

FRIEDBERG'S

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The market takes command

Orchestration is out. Markets are in. For the first time in four years, stunned policymakers are being forced to react to events. Trying to cope with what is about to unfold could turn their dreams into a nightmare.

The story of disinflation is the amazing story of how we managed to fool most of the people for such a lengthy period of time. This neat magic worked so well that it made history: We came to adore the Velocity God because it behaved in the most perverse way in 50 years. Never mind that velocity slowed down because people *believed* that governments had embarked on a zero-inflation crusade. If you could keep people believing that, then you could do wonders: create capital and wealth by printing money and extending credit. You could keep an economic recovery going forever by simply piling debt upon debt. (For a chapter-and-verse account of this process, read "There's trouble in paradise".)

Disinflation was accompanied by a lot of deception and a little bit of luck. The historically high real prices achieved in the decade of the '70s caused significant changes in the supply and demand for internationally-traded commodities. Furthermore, as the IMF points out in a publication called *Primary Commodities: Market Developments and Outlook May 1986*, the "deceleration in the rate of growth of economic activity... contributed to the weakness of commodity prices in the 1980s compared with the preceding decade..." Increased supply, falling demand (as a result of price and income elasticities) and a dramatic rise of the US dollar from 1980 to 1985) conspired to produce a large drop in commodity prices (see Chart 1) and a *sensation of deflation* when in fact it was merely a relative price adjustment that was taking place. The Fed's anti-inflation oracles were thus reinforced.

The disinflationary trend fed itself. The public accelerated its demand for financial assets, producing the so-called drop in velocity. The collapse of oil prices convinced the crowd: We had to heed the disinflationists; there was even a chance for outright deflation.

Never mind that the dollar had crumbled. Never mind that the budget deficit had risen well beyond everyone's guess just six months earlier. Never mind that M1 was growing at 15%-18% rates per annum. There were answers for everything: The dollar was merely "returning" to a more normal valuation; the budget deficit did not matter, as the Fed was not

monetizing and foreigners were willing financiers — and, at any rate, Gramm-Rudman would fix it; M1 for technical reasons did not count anymore — it was better to concentrate on the broader measures such as M2 and M3, which had been growing at more moderate rates (although, of late, *they too* have exceeded targets; and by the way, what did happen to the debt proxy?). Finally, all was well as long as commodity prices, and particularly *gold*, remained weak or about steady. The Commodity Standard was embraced by a number of enlightened supply-side economists, chief among them some Federal Reserve Board members. The editors of *The Wall Street Journal* in a number of provocative articles sort of accused the Fed of being *too restrictive* in view of the stability of gold prices.

Some of the people, most of the time. But certainly not most of the people all of the time. Awakened from their torpor, markets have begun to articulate their fears. At first they will merely taunt the Fed. Later, they will render it helpless. In the end, they will force the Fed to bite the bullet. By then, the disinflationists/deflationists will have been ravaged.

Inflationary signs have finally surfaced. Import prices are rising. Services are rising. Residential prices in many parts of the nation are soaring. Commodity prices have firmed (see Chart 2). And, most importantly, gold prices have broken out on the upside after a prolonged base-building period, last week reaching three-year highs. As if to confirm this phenomenon, the yield curve has widened to its widest slope in many years (measured on a percentage basis). Worldwide, the stock markets have signalled the end of the disinflation myth by tumbling, in unison, in one of the most spectacular sell-offs in recent years.

In this issue

There's trouble in paradise: stock prices on the way down, gold prices on the way up, and a banking system on the verge of failure. So we short the S&P 500 and stay long gold. As for currencies... gold is still a better "play." And unless Iran emerges the clear-cut victor, oil prices will resume their downtrend... stay short. Contributions by Albert D. Friedberg, Steve H. Hanke, and Daniel A. Gordon.

The Fed cannot sit idly by and allow the enormous liquidity built up over the past five years to mobilize and push inflation back into double-digit territory by mid-1987. But can it act? We do not like to get ourselves ahead of the story, as our colleague discusses in some detail in the following article some of the numbers involved and the possible constraints.

The US monetary authorities have aided and abetted in the creation of a monster. The nightmare begins.

Chart 1

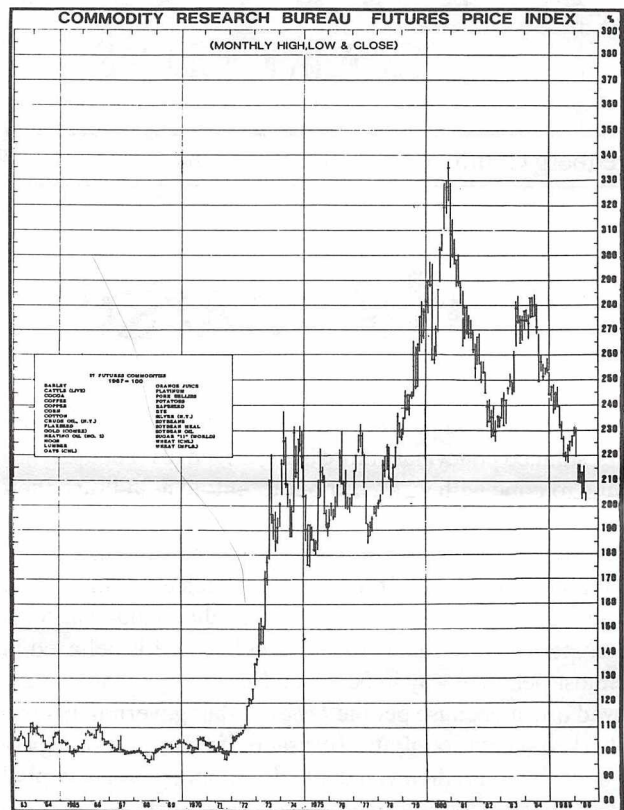
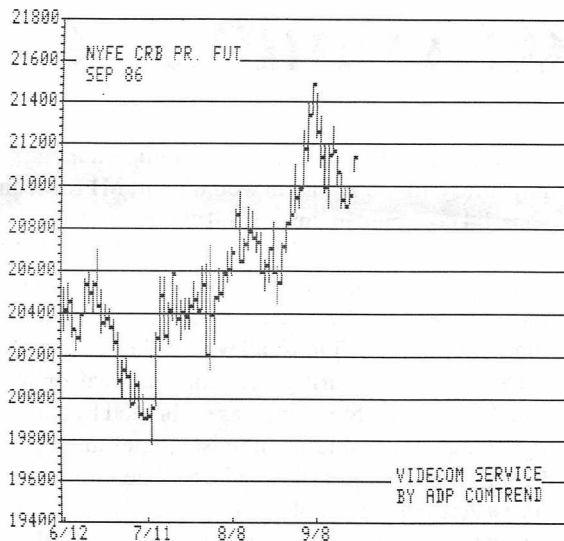


Chart 2



There's trouble in paradise

For some time, Wall Street has resembled a financial paradise. Fueled by talk of disinflation (lower long-term interest rates) and an imminent resurgence in real economic growth, stock and bond prices have soared.

We have been most uncomfortable with this vision. Firstly, our analysis has shown that announcements of inflation's death have been premature (FC&CC March 23, 1986, and June 22, 1986). Secondly, our profile of the economy hasn't included a second-half boom for 1986. In fact, we have anticipated some negative numbers by year's end (FC&CC January 19, 1986, April 20, 1986, and August 17, 1986). If this weren't enough, we now believe that over-indebtedness — and the economic and financial instability that it is spawning in the US — promises to produce a dramatic realignment in the markets for financial (noninflation) versus tangible (inflation) assets and US versus foreign assets.

Debt's quantity profile — One dimension of over-indebtedness (excessive credit creation) is the quantity dimension (see Chart 3). Throughout most of the 1960s and 1970s, debt of the nonfinancial sectors displayed a rather stable relationship to gross national product (GNP). For example, during the 1970s, the total debt of domestic financial sectors stayed in a narrow range, between 136% and 138% of GNP. But, with the start of the new decade, total debt exploded to 169% of GNP at the end of 1985 from 138% of GNP in 1980. Let's take

a closer look at the composition of this growth.

In the period 1981-85, federal tax revenues rose at roughly the same rate as the GNP. Since federal expenditures rose much more rapidly than GNP, federal borrowing had to be used to finance the gap between expenditures and tax revenues. In consequence, federal borrowing grew much more rapidly than GNP. This divergence in growth rates is unusual. Typically, during the recovery phase of a business cycle, the growth in GNP exceeds that of federal borrowing.

The rate of growth in household debt actually slowed each year from 1979 to 1982. Since then, however, it has surged and outpaced GNP growth. Moreover, in the 1980s, household debt growth has exceeded that of disposable income, with disposable income growth averaging about 8% per year and household debt growth averaging about 10.5%. Household debt, like federal debt, is exhibiting an atypical behavior. During the final stages of a business cycle recovery, when the economy begins to slow down, households tend to shy away from taking on more debt. Currently, however, households are going into debt at a record pace.

Even though the growth rate of nonfinancial business debt has been slightly less in the 1980s than in the 1970s, the growth in this debt has outpaced GNP growth. Of particular interest is the fact that nonfinancial business borrowing exceeded underlying borrowing needs — measured by the dif-

ference between capital expenditures and internal funds generated from retained earnings and depreciation allowances — by a wide margin. Between 1981 and 1985, borrowings were 3.5 times greater than underlying borrowing needs.

Borrowing by state and local governments has moved up briskly for a number of years. It reached staggering proportions in 1985 because pending legislation, if passed, would restrict the use of state and local borrowing for private purposes. In anticipation that they would have to face these restrictions by 1986 or 1987, state and local governments filled their war chests in 1985.

Debt's quality profile — The rapid build-up in quantity of debt has been accompanied by a significant deterioration in credit quality. This decline in quality has been most noticeable in the business sector. Since the recovery phase of the business cycle began in 1982, more credit ratings have been downgraded than upgraded. In the first-half of 1986, credit ratings were being lowered twice as frequently as they were being raised. In consequence, over the past decade, the number of AAA-rated industrial and utility corporations has fallen to 26 from 56. Over the last 10 years, the number of large bank holding companies whose paper is rated AAA has fallen to one from 14. During this period, the high-yield corporate bond market (bonds with credit ratings below BBB) has grown to 21% from 9% of total outstanding corporate debt.

A major contributor to the decline in the quality of business debt has been increased leveraging of businesses. While debts have increased, equity levels have actually declined.

Credit quality has deteriorated in other sectors, too. In the state and local government market, credit quality declined for the seventh consecutive year in 1985. For households, delinquency rates on all loans have shot up; foreclosure rates on home mortgages are increasing; and bank writeoffs for bad credit card loans more than doubled from the first-quarter of 1985 to that of 1986.

It is worth noting that problem real estate loans — which have resulted, in large part, from an over-building of commercial property — ballooned to \$12.6 billion in the first-quarter of 1986 from \$11.3 billion in the same period of 1985. At the end of the first-quarter of 1986, real estate that creditors had acquired through foreclosures or defaults and were still holding was valued at \$7.6 billion, which was up from \$6.5 billion at the end of the first-quarter of 1985. Agriculture also merits special attention. After peaking in 1981, the value of farmland has fallen by 25%, while farm debt has continued to grow. In consequence, farmers' net worth has fallen by 30% during the past five years. It's not surprising that problem farm loans held by federally-insured banks have shot up to \$3.1 billion in the first-quarter of 1986 from \$1.6 billion in the first-quarter of 1985.

Consequences of the credit boom — Most credit booms are characterized by over-investment, which ends in an economic slump. This excess hasn't been associated with the current boom. Instead of over-investment, the current credit boom is characterized by over-consumption and massive speculation in financial assets.

Consumers have borrowed heavily, so that they could increase their consumption levels and speculate in the stock and bond markets. Businesses have borrowed well beyond their underlying borrowing needs, so that they could buy back their own stock and/or play the mergers and acquisitions game. As we pointed out in the last issue of FC&CC, corporate treasurers have represented the largest group of speculators in the stock market of late. Corporations have found rates of return in stock speculation to be higher than those in investments in plant and equipment, where expenditures have been weak and concentrated in short-lived office equipment, computing and accounting machinery, cars and trucks and commercial office buildings. Government has borrowed, so that it could proceed on an unprecedented peacetime spending binge that has been characterized by pure waste and consumption, with very little being invested in productive enterprises.

It is interesting to mention that the over-indebtedness, which has fueled over-consumption and financial speculation, hasn't spawned much concern about inflation because the excesses created by the massive inflation in credit haven't found their way into traditional price indexes.

Inflationary credit, which has been used for consumption, has been absorbed, in part, by imports of foreign goods. Imports have allowed a great deal of our inflationary credit to be siphoned out of our domestic markets. In consequence, domestic price indexes have been lower and foreign ones higher than they would have been without America's surging imports.

Another market that has absorbed inflationary credit is the stock market. The stock market has acted to temporarily tie-up inflationary credit, which has created a "localized inflation" in stocks. But, stock prices aren't included in traditional price indexes.

Consequences of the coming economic slump — In light of our current state of over-indebtedness — as well as some ill-timed, if not ill-conceived, government policies, which we will discuss below — the coming slump promises to spread havoc among America's banks. This will, of course, spill over into all of the financial markets. To properly develop an investment strategy, therefore, our first priority must be an understanding of the slump's consequences for the banks.

First, the slump will mean that the rate at which marginal loans turn sour will increase. In consequence, there will be even more foreclosures and defaults, and the banks' charge-offs, net of recoveries, will accelerate. In addition to increasing the number of bad loans, the slump will produce a liquidation of some good loans. As debtors begin to see that a resurgence in economic activity is not around the corner, they will begin to liquidate unwanted debt. This liquidation of some of the banks' highest quality loans will have important consequences for banks. It will immediately lower the average quality of banks' assets. Liquidation will also result in a reduction in banks' leverage (the ratio of assets to equity). This means that the banks' return on equity will fall. In an attempt to offset this consequence, the banks will try to increase their returns on assets. Since this can be accomplished only by funneling the funds made available by the loan liquidations

to lower quality loans, it means that the liquidation process will put in place a set of dynamics that will generate lower credit quality. This is a rather sobering prospect, given that credit quality has been plunging throughout the entire recovery phase of the current business cycle. For its part, then, the slump will squeeze banks' profits and reduce the quality of their assets.

In addition to cyclic causes, government policy will also act to put an extreme squeeze on banks' profits and asset quality. As part of the so-called Baker Plan, which is intended to ease less developed countries' (LDC) debt problems, banks are being "forced" to participate in questionable LDC loan reschedulings on increasingly unattractive terms. The recent agreement with Mexico provides clear evidence on this point.

The pending tax reform, if passed, will also work against bank profits. For banks with more than \$500 million in assets, the provisions for deductibility of loan losses will be tightened. These new restrictions, which will increase taxable income and reduce after-tax profits, will come into play during a period when loan losses are soaring and the liberal treatment of their deductibility is most needed.

Tax reform would also eliminate the banks' deductibility of interest expense for holding tax-exempt state and local securities. This will reduce the attractiveness of holding these relatively high quality assets.

In consequence, bank portfolios will yield somewhat less after taxes, and their quality will be somewhat reduced.

If this weren't enough, tax reform will eliminate certain benefits that now flow from real estate investments. In consequence, foreclosures and defaults in this sector, which are already at alarmingly high levels, will increase, and banks will be forced to further increase their inventories of unwanted real estate.

The last blow that the tax reform will inflict on banks comes via the restrictions on individuals' deductibility of interest on consumer loans. This will result in increased costs of consumer credit for users. To maintain volume in this profitable market, it is anticipated that banks will have to reduce their consumer credit profit margins, which are now the highest of any bank asset category. This will put an additional squeeze on bank profits.

That our over-indebtedness, in concert with an economic slump and misguided government policies, will create serious troubles for America's banks is an understatement. To put this picture into focus, just consider the following. In the first-quarter of 1986, 390 banks (more than at any time since the 1930s) had problem loans that exceeded their loan loss reserves and equity combined. This number compares with 288 in the first-quarter of 1985. What's more, 1,947 banks lost money in the first-quarter of 1986, versus 1,763 in the same 1985 period. It's not surprising that 100 banks have already failed this year and that this number might rise to 160 by year's end. This would surpass the post-Depression record of 120, which was set last year.

Anticipated policy response — The picture that we have painted might lead one to conclude that we support the thesis

developed by Professor Irving Fisher in his famous article, "The Debt-deflation Theory of Great Depressions," which was published in the October 1933 issue of *Econometrica*. Professor Fisher argued that disinflation swells the burden of debts, and over-indebtedness leads to debt liquidation, which engenders a shrinkage of the money supply and a deflation.

While we have no quarrel with Professor Fisher's logic, we believe that the Federal Reserve Bank will not allow it to run its course. As the banking system becomes increasingly stressed, the Fed will be forced to behave like a financial Saint Bernard: It will accommodate the "needs" of the banking system in hopes of performing a giant rescue operation. This will work to dramatically change market psychology: exit anticipated disinflation; enter anticipated inflation. In consequence, there will be shifts in portfolios: from the US to abroad and from financial assets to selected types of tangible assets. In addition, there will be a flight to quality.

STRATEGY: *The Fed will continue to put downward pressure on short rates, but it won't be translated into lower long-term yields. With rising inflation expectations, long rates will rise. Long rates will also receive a good bit of upward pressure as foreigners, not wishing to suffer more losses in the bond and US dollar markets, fold their tents and move on. In short, the spread between short and long yields will continue to widen, with the yield curve becoming steeper.*

Driven by higher long rates, the stock market's big present valuing machine will knock down stock prices.

The precious metals, particularly gold, haven't yet seen their best days.

Faced with the need to rescue a failing banking system, the Fed might well have to cast the dollar to the winds that accompany a free fall.

— By Steve H. Hanke

Chart 3. Domestic Nonfinancial Debt and Borrowings

Category	1971-75, average	1976-80, average	1981	1982	1983	1984	1985
Annual percentage change, end-of-period basis							
<i>Debt</i>							
Federal	8.4	10.8	11.8	19.4	18.8	16.9	16.2
Nonfederal	10.1	11.7	9.0	6.8	9.7	14.0	14.6
Households	9.8	12.5	8.3	5.6	11.3	13.0	14.1
Nonfinancial business	11.0	11.8	11.1	7.6	7.7	15.4	11.3
State and local governments	8.2	6.1	2.3	8.5	11.4	12.2	34.2
Total	9.7	11.6	9.5	9.2	11.6	14.7	15.0
MEMO: Growth of nominal GNP	10.3	11.2	9.3	3.2	10.0	9.0	5.4
Average annual amounts, billions of dollars							
<i>Net borrowing</i>							
Federal	29	59	87	161	187	199	224
Nonfederal	139	274	285	234	356	567	674
Households	37	139	120	88	187	239	294
Nonfinancial business	68	120	159	120	131	383	240
State and local governments	14	15	7	26	38	45	141
Total	168	333	373	395	543	766	898

Source: Federal Reserve Bulletin, August 1986.

Stock Indexes

There can be little doubt that the Great Bear Market of 1986 has begun. The synchronized (worldwide) plunge (a title we used a bit prematurely last May 18), the seeming perplexity associated with the 86-point drop recorded on September 11, the still-pervasive confidence that long term, this bull market will see Dow Jones at 3000, the disastrous performance of the secondary sector (a euphemism for the entire stock market except a very *select* number of high capitalization stocks) since June of this year, etc. all point to a significant market reversal.

Every major trend has a theme. In the 1982-86 bull market, actual earnings did not matter a great deal because earnings were always thought to be rising in the subsequent two to four quarters. Earnings *never did* improve and as a result price-earning ratios rose. Ironically, high P/E ratios were rationalized in fancy dividend and earnings discounting models that used low and falling interest rates. In short, it did not matter if earnings were correctly forecast — one could always fall back on the perfectly rational thesis that in a disinflationary economy, with low and falling interest rates, one dollar of dividends/earnings was worth ever more. There was no way to be wrong.

The 1986-? bear market will be a mirror image of the above thesis. Rising long-term rates will lower the present value of the coming stream of earnings and dividends, which in turn will be falling as the economic slump deepens. The double-barrelled effect of rising interest rates and anticipated falling earnings will lower P/E ratios dramatically. A return to a more "normal" 8-10 P/E ratio (prevalent in the late '60s and '70s) should bring stock prices down by anywhere between 40% and 60%.

Institutional buying habits, backed by sophisticated dividend discount models, have led to an overexploitation of stocks with large capitalizations and of senior companies to the detriment of secondary stocks. This phenomenon first pointed out in our May 18 issue, caused the Standard & Poor's 500 Index (narrow and weighted by capitalization) to outperform dramatically the Value Line Index of 1,700 companies (broader and *not* weighted by capitalization). From mid-1983 to date, the Value Line/S&P ratio spread moved from 1.22 to 0.93. (see Chart 4). The coming contraction in multiples *should hit the S&P 500 Index relatively harder than the Value Line Index.*

STRATEGY: *On Sept. 5, our Hotline Update recommended initiating short positions on the December '86 S&P Index at the market (See review). By Sept. 17, this stroke of good fortune had earned us approximately 1,800 points (\$9,000 per contract), which we advised nailing down ahead of the "triple witching hour" of last Friday. After the close of Friday, we advised reinstating short positions via the December '86 S&P. Initial stops are set at 23650, close only.*

On the same fateful Sept. 5, we also advised entering the short S&P/long Value Line spread. In our view, this spread represents the most conservative play of the unfolding bear market, although clearly it does not have the profit potential of an outright sale. Since, at present levels, the S&P contract is larger than the Value Line contract, a one-for-one spread carries a small short position (equal to about \$6,000). Retain spread. Risk a widening to 2,000 points, basis the cash indexes.

Chart 4

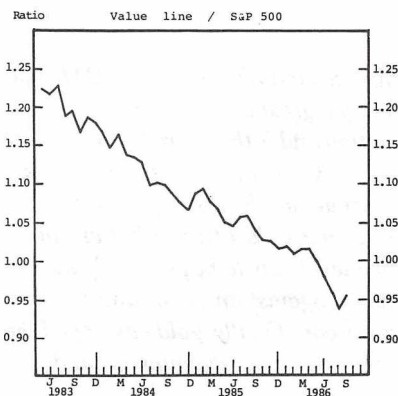


Chart 5

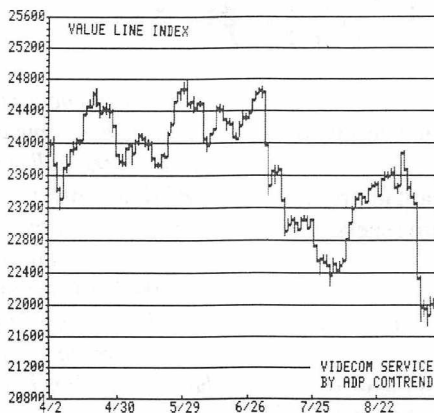
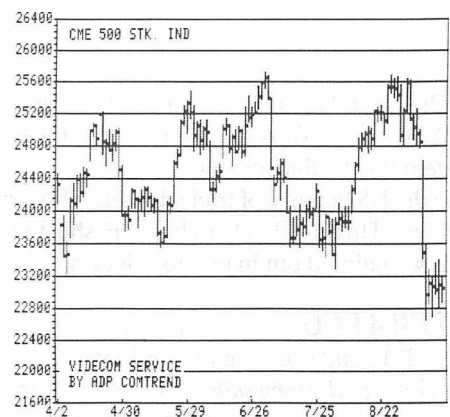


Chart 6



Gold

Despite the very sizable advance that has already occurred, our enthusiasm for the yellow metal grows daily. Disinflationists points to the GNP deflator (1.8% annual rate) and to the extremely low rate of inflation in unit labor costs to deny validity to gold's bull move. When pressed to explain gold's seemingly bizarre behavior, disinflationists attribute it to unrest in South Africa and/or the purchase of gold by Japan for the purpose of fabricating a gold coin commemorating Emperor Hirohito's 60th anniversary.

The disinflationists fail to distinguish between inflation, a truly monetary phenomenon, and rising prices: The latter is merely a reflection or manifestation of the former that can be repressed by various means and for lengthy periods of time. Denying gold's sensitivity to inflation is akin to breaking the thermometer.

STRATEGY: *Remain firmly long, having added to positions on a switchover from platinum.*

Chart 7

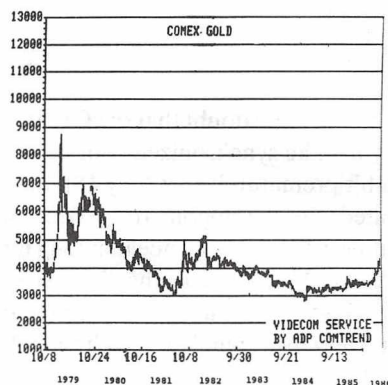


Chart 8

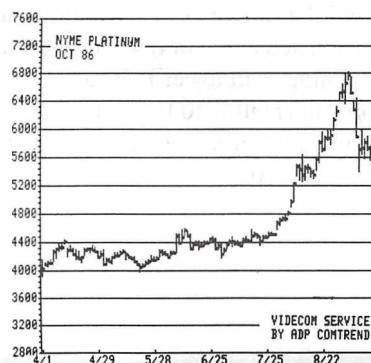


Platinum

The speculative bubble was overdone and we said so (see Hotline review, Sept. 10), nailing down profits in excess of \$250/oz.

STRATEGY: *Sentiment gauges and open interest indicate that the market remains overbought. For now, gold is a safer and more rational play.*

Chart 9



Currencies

The US dollar is likely to move lower as long as
 1) Japan and West Germany do not take concerted action to stem the decline and/or
 2) the US balance of trade does not show significant improvement. This is unlikely to happen, short of a severe recession, as we pointed out in previous issues.

STRATEGY: *We took very substantial profits on our long SF, DM, and yen positions on Sept. 11. On Sept. 17 we decided to reenter the long side of the SF and DM (and not the yen), as it appeared that a new upleg was in the making. Mr. Baker's dollar-bashing speech of last Thursday confirms the trend. The*

yen seems to be weakening considerably against the DM. The Japanese economy is suffering a great deal more than Germany's from the dollar devaluation and is therefore likely to resist further yen revaluations, at least for the near term. This explains our reluctance to reinstate new long yen positions.

We continue to believe that gold offers a better "play" than the hard currencies; it is less likely to be politically manipulated and it offers protection against an all-around banking crisis better than any currency can. Finally, gold has lagged the hard currencies but now appears to be regaining ground (see Chart 13).

Chart 10

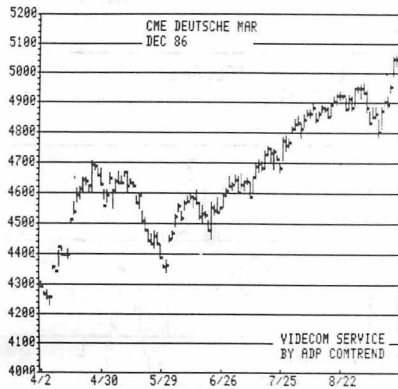


Chart 11

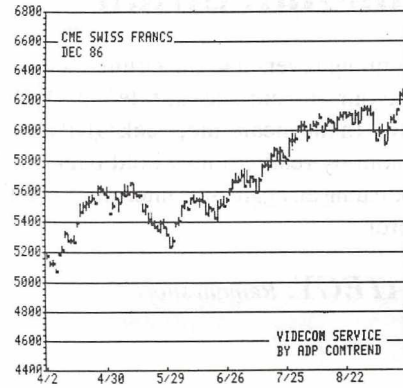


Chart 12

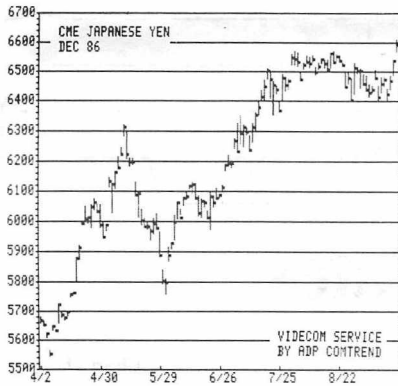
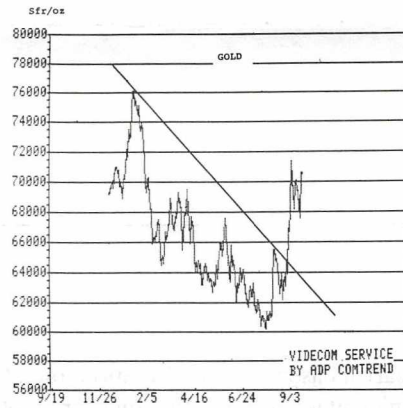


Chart 13



British pound

Our cross trade continues to shine (Charts 14 and 15).

British problems continue to mount as long-term interest rates soar (see Chart 16) in the face of rising unemployment. A sense of crisis is gaining ground as the Tories approach the 1988 election. It will be either fiscal reflation or devaluation: Last week it looked like the latter.

STRATEGY: Maintain spread.

Chart 14

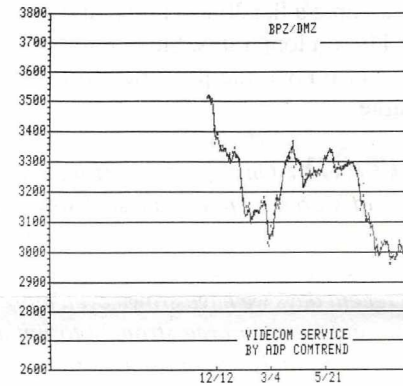


Chart 15

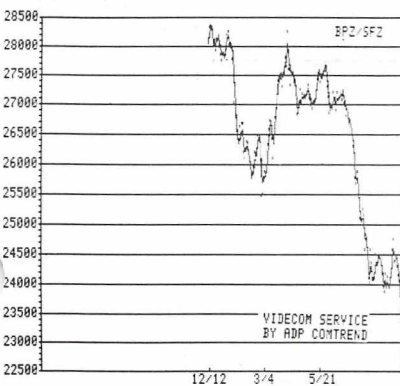


Chart 16

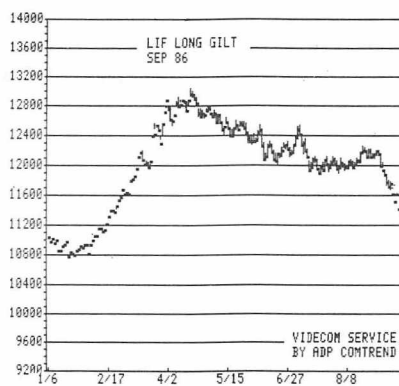
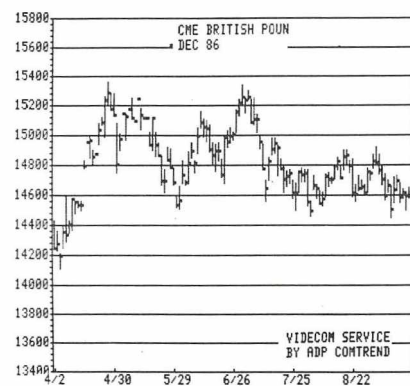


Chart 17

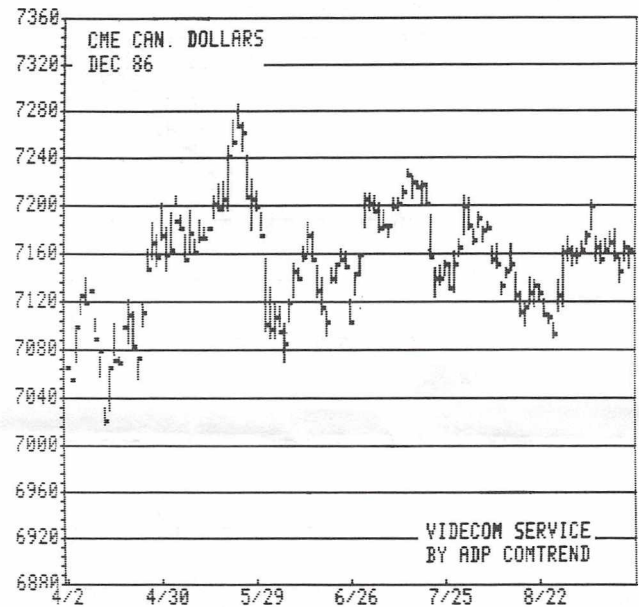


Canadian dollar

The stunning reversal in the country's trade balance is likely to make our current account deficit of \$10 billion too conservative. In the meantime, weak GNP numbers (second negative monthly reading) may hold back the Bank of Canada from pursuing an aggressive interest-rate policy, the currency's main prop.

STRATEGY: *Remain short.*

Chart 18



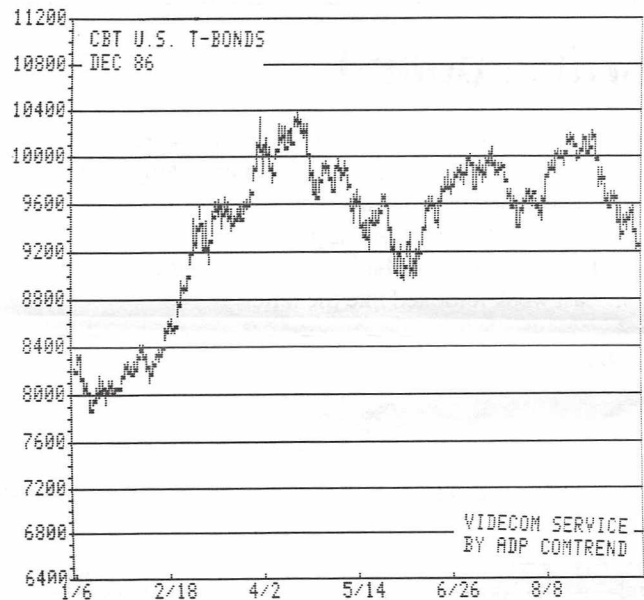
Interest Rates

Our bearish case is simple. Inflation, on a CPI basis, should be running at 6.5% by the first quarter of 1987. Add one percentage point to compensate bondholders with a modest real return, assume a flat 30% tax rate, and you arrive at approximately 11% on long rates. Since rates on 30-year Treasuries now border on 8%, the potential profit on bear positions is quite large.

STRATEGY: *On Sept. 5 our Hotline advised purchasing two units of March '87 put options, 88 strike, hoping to sell half the position for enough of a gain to recoup the initial outlay. These puts should have been bought around 1 41/64.*

In recent days we have grown even more confident of this position, and we now urge strongly to initiate or add to the short side of T-bonds. On outright positions, place stops at 98, basis December '86, close only.

Chart 19



Crude Oil

US product inventories continue to mount. The impact on refining margins has been devastating (see Chart 20), a bad omen for crude prices.

The much announced Iranian all-out offensive has not yet materialized. In recent weeks, Iraq has been relatively effective in the use of its air force against Iranian oil installations. It is likely that Iranian net exports of oil have been reduced to less than 500,000 barrels per day (b/d), a far cry from their present potential to export 1.5 million b/d. Lower export volume combined with low prices *should* slowly strangle Iran's war-making capacity. As long as the demoralized Iraqis don't crumble sooner...

STRATEGY: Short of an Iranian clear-cut victory, oil prices will resume their downtrend.

Remain short, leaving stops at 16.60, basis November '86, close only.

Chart 20

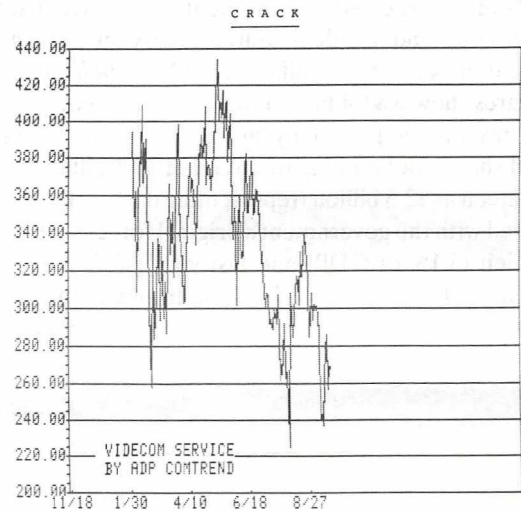
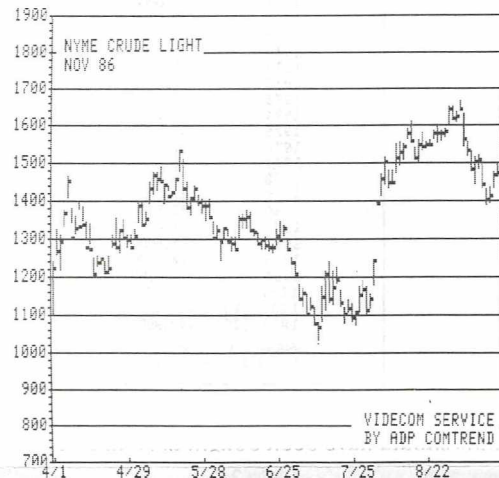


Chart 21



Chart 22



The Exotics

Greek drachma

The October 1985 austerity package can hardly be considered a success. As we said at the time, the package is "wrought with contradictions and inanities, the typical result of the muddled thinking of socialists." Price inflation has declined marginally, showing a 17.6% annual rate for the first six months of 1986, compared with an 18.4% annual rate in the corresponding period a year ago. Since inflation tends to accelerate in the second half of the year, especially since in July the gov-

ernment passed a surprise 15% increase in the prices of basic services such as electricity, telephone, water, the post office, and railway and airfares, we estimate that the full year will record a minimum 25% inflation rate, a stunning failure. Not surprisingly, monetary measures, such as broad money supply and domestic credit, continue to soar well beyond the nation's productive capacity.

On the external front, the trade deficit for the first quarter of 1986 at \$1.45 billion dollars was only \$150 million lower than the deficit recorded in the first quarter of 1985, despite

the fact that the country saved over \$210 million due to lower oil prices. For the full year, the government anticipated that it will save approximately \$1.2 billion due to lower oil prices, assuming a price of \$15 per barrel. These savings account for 75% of the expected improvement in the current account deficit. Other independent sources, however, estimate the saving at closer to \$650 million. First-half 1986 current account figures show a \$1.4 billion deficit, a 30% reduction from the corresponding period a year ago. Full-year figures probably will show a deficit of a minimum of \$2.1 billion and perhaps as much as \$2.5 billion (representing 6.3%-7.6% of GDP) compared with the government's original forecast of a \$1.7 billion deficit (5.1% of GDP) and last year's deficit of \$3.3 billion (equal to 10.1% of GDP). This disastrous external performance has taken place despite a system whereby importers are re-

quired to put up 80% of the value of imports with the Bank of Greece six months before taking the goods.

While the government's economic measures yielded some positive returns in the public sector area where the budget deficit has dropped by 25% from last year, this improvement is only relative; the public sector deficit is still equal to at least 14% of GDP during 1986.

STRATEGY: Greece remains a basket case. Despite heavy forward discounts, we have managed to trade the Greek drachma profitably from the short side by hedging out the US dollar risk via long positions in DM. Forwards trade at a 30% per annum discount, a not unrealistic expectation. Remain short vis à vis DM, neutral against the US dollar.

Chart 23

YEAR	GREEK DRACHMAS PER U.S. DOLLAR (PERIOD Aug)	U.S.		BASKET	
		1973 =1.00	1978 =1.00	1973 =1.00	1978 =1.00
1967	30.0000	0.9993	1.1284	0.8542	0.8262
1968	30.0000	1.0370	1.1711	0.8405	0.8129
1969	30.0000	1.0679	1.2060	0.8609	0.8327
1970	30.0000	1.1002	1.2424	0.8953	0.8659
1971	30.0000	1.1131	1.2570	0.9456	0.9146
1972	30.0000	1.1028	1.2453	1.0053	0.9724
1973	29.6250	1.0000	1.1293	1.0000	0.9672
1974	30.0000	0.8853	0.9997	0.8894	0.8602
1975	32.2870	0.9167	1.0352	0.9742	0.9423
1976	36.5180	0.9695	1.0948	1.0085	0.9755
1977	36.8380	0.9285	1.0485	1.0042	0.9713
1978	36.7450	0.8855	1.0000	1.0339	1.0000
1979	37.0400	0.8343	0.9421	1.0198	0.9863
1980	42.6200	0.8728	0.9856	1.0811	1.0457
1981	55.4100	1.0062	1.1363	1.0614	1.0267
1982	65.8000	1.0637	1.2012	1.0292	0.9955
1983	88.0600	1.2012	1.3565	1.0826	1.0471
1984	112.7200	1.3570	1.5324	1.1133	1.0768
1985	138.1200	1.4424	1.6289	1.1482	1.1106
1986 (1Q)	144.6200	1.3209	1.4917	1.1829	1.1441
1986 (2Q)	140.9900	1.2362	1.3960	1.1500	1.1123

Japan 07% Italy 16%
France 11% Netherlands 09%
Germany 30% Saudi Arabia 11%
UK 08% IS 08%

Above 1.00 = undervalued
Below 1.00 = overvalued

Chart 24

Year	Foreign Assets (Min US\$)	CURRENT ACCOUNT		CUMULATIVE 12 QTR.
		As % of GNP	%	Current Account (Min US\$)
1970	356	-4.15		-1048
1971	396	-3.05		-1127
1972	853	-3.09		-1166
1973	771	-7.08		-1933
1974	543	-5.89		-2732
1975	165	-4.06		-3209
1976	-418	-3.99		-2949
1977	-822	-5.98		-2881
1978	-1347	-2.93		-2959
1979	-1615	-4.74		-3916
1980	-1319	-5.32		-5050
1981	-1768	-6.33		-6503
1982	-2386	-4.84		-6509
1983	-2486	-5.36		-6178
1984	-2772	-6.37		-5902
1985	-2069	-10.18		-7310

Chart 26

RATES	SPOT	1 MONTH	3 MONTH	6 MONTH	12 MONTH
	132.90-	136.40-	142.40 -	152.40 -	157.90 -
	133.00	138.50	146.50	158.50	173.00

Chart 25

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

Reserves * + Previous 12-months current account *** = 232
(Reserves + 12-months C/A) / M1 ** = 232/4517 = 5.1%
(Reserves + 12-months C/A) / Broad Money ** = 232/19853 = 1.1%
*As at June 1986 ** Jan. 1986 *** 1986 Estimated

Figures in millions of U.S. Dollars

	M1 (Converted to U.S. Dollars)	Broad Money (Converted to U.S. Dollars)
1975	3.663	9927
1986 (Jan)	4.517	19853

% Increase 23.31% 99.99%
(decrease)

Corresponding % increase in the United States 112.51 143.39

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

Source: IFS

Norwegian krone

Economic boom conditions in Norway over the past number of years caused an external sector crisis once oil and gas revenues collapsed. Even as total exports fell from Kr117.6 billion to Kr97.6 billion in the first six months of this year, imports rose a stunning 13% to Kr105 billion. While the June 23 devaluation against its major trading partners formally amounted to 12%, in practice the krone has depreciated only a little less than 6.5% against the DM. Of course, it has appreciated by 5.6% against the dollar. Unless the new Labor government

takes strong measures to tighten its belt and adjust to the dramatic fall in the terms of trade, Norway may have to resort to another series of devaluations. On the other hand a government-induced slowdown, given the country's relatively healthy state of finances, can accomplish the necessary adjustments without resorting to any further currency depreciations.

STRATEGY: Forward discounts against the US dollar remain rather steep, providing sufficient cushion in case of another devaluation. We therefore remain long against the US dollar and neutral vis à vis the DM.

Chart 27

YEAR	NORWEGIAN KRONER PER U.S. DOLLAR (PERIOD Aug)	U.S.		BASKET	
		1970=1.00	1979 =1.00	1970 =1.00	1979 =1.00
1967	7.1504	1.0146	1.5465	1.1103	1.1856
1968	7.1430	1.0185	1.5524	1.0119	1.0806
1969	7.1444	1.0450	1.5928	1.0357	1.1059
1970	7.1471	1.0000	1.5242	1.0000	1.0678
1971	7.0436	0.9648	1.4705	1.0211	1.0904
1972	6.5882	0.8731	1.3308	0.9834	1.0501
1973	5.7658	0.7531	1.1478	0.8833	0.9432
1974	5.5397	0.7344	1.1194	0.8584	0.9166
1975	5.2269	0.6775	1.0326	0.8424	0.8995
1976	5.4565	0.6858	1.0454	0.7879	0.8413
1977	5.3235	0.6528	0.9950	0.7835	0.8367
1978	5.2423	0.6403	0.9760	0.8378	0.8947
1979	5.0641	0.6561	1.0000	0.9365	1.0000
1980	4.9392	0.6559	0.9997	1.0162	1.0852
1981	5.7395	0.7400	1.1280	1.0030	1.0710
1982	6.4540	0.7927	1.2083	0.9642	1.0296
1983	7.2964	0.8531	1.3004	0.9337	0.9970
1984	8.1615	0.9367	1.4277	0.9238	0.9865
1985	8.5972	0.9661	1.4726	0.9431	1.0070
1986 (1Q)	7.3197	0.8065	1.2293	0.8822	0.9420
1986 (2Q)	7.4030	0.8003	1.2199	0.9221	0.9846

U.S. 09% UK 35%
 Netherlands 7% Sweden 19%
 Germany 23% Denmark 7%

Above 1.00 = undervalued
 Below 1.00 = overvalued

Chart 28

Year	Foreign Assets (Min US\$)	CURRENT ACCOUNT As % of GNP	CUMULATIVE 12 QTR. Current Account (Min US\$)
1970	893	-2.1	-106
1971	1061	-4.1	-640
1972	1248	-0.4	-827
1973	1514	-1.9	-950
1974	1769	-4.8	-1542
1975	2150	-8.8	-3961
1976	2042	-12.2	-7342
1977	1928	-14.3	-11258
1978	2785	-5.3	-10883
1979	3560	-2.3	-8181
1980	3909	1.9	-2049
1981	4725	3.9	2231
1982	5232	1.2	3937
1983	4732	3.7	4825
1984	6831	5.5	5386
1985	8606	5.1	7888
1986 (1)	7522	-	7645

Chart 30

RATES	SPOT	1 MONTH	3 MONTH	6 MONTH	12 MONTH
	7.2250-	7.2690-	7.3650 -	7.5040 -	7.7600-
	7.2300	7.2780	7.3750	7.5150	7.7775

Chart 29

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

Reserves * + Previous 12-months current Account *** = 16155

(Reserves + 12-months C/A) / M1 ** = 16155/13117 = 123%

(Reserves + 12-months C/A) / Broad Money ** = 16155/41005 = 39%

*As at June 1986** March 1986 *** 1985 (1)-1986(1)

Figures in millions of U.S. Dollars

	M1 (Converted to U.S. Dollars)	Broad Money (Converted to U.S. Dollars)
1976	6,252	24,702
1986(March)	13,117	41,005

% Increase (decrease)

	109.8%	66.0%
--	--------	-------

Corresponding % increase in the United States

	98.2%	115.5%
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(a) 1985 Imports as percentage of GNP 26.90
 (b) 1976 - 1985 Imports as percentage of GNP 29.29
 1985 / 1976 - 198 average = (a)/(b) = .9184

Source: IFS

Forex Rates & Update

Currency	Spot	3-Month	12-Month	Comments vis à vis US\$	Comments vis à vis DM (Spot DM 1.99)
Australian dollar	.6285-.6290	.6108-.6118	.5685-.5700	Remain long	Remain long
Belgian franc	41.35-41.40	41.46-41.55	41.70-41.90	Remain long	Remain long
Danish krone	7.5600-7.5650	7.6140-7.6215	7.7950-8.0250	Neutral	Remain short
Dutch guilder	2.2515-2.2525	2.2471-2.2486	2.2315-2.2355	Remain long	Remain long
Italian lira	1376-1380	1378-1382	1382-1387	Remain long	Neutral
Kuwaiti dinar	.29070-.29100	.29144-.29211	.29267-.29436	Neutral	Remain short
Malaysian ringgit	2.6300-2.6320	2.7025-2.7145	2.7600-2.9120	Neutral	Neutral
New Zealand dollar	.4730-.4745	.4627-.4652	.4335-.4390	Remain long	Remain long
Portugese escudo	144.50-144.85	147.65-149.00	151.55-161.85	Neutral	Neutral
Saudi Arabian riyal	3.7500-3.7510	3.7600-3.7640	3.8000-3.8110	Remain short	Remain short
Singapore dollar	2.1605-2.1615	2.1465-2.1485	2.1230-2.1340	Neutral	Neutral
Spanish peseta	131.75-131.95	133.25-133.95	137.50-138.70	Neutral	Neutral
Swedish krona	6.8175-6.8225	6.8735-6.8825	7.0000-7.0150	Remain long	Neutral
Venezuelan bolivar	20.20-20.25	20.30-20.90	20.60-21.50	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

Sell

Sell

Buy

Sell

Sell

Buy

Cover

Liquidate

Hotline Update

Tuesday, August 19: No changes or new recommendations.

Friday, Aug. 22: No changes or new recommendations. Market letter is in the mail.

Tuesday, Aug. 26: No changes or new recommendations.

Friday, Aug. 29: No changes or new recommendations.

Tuesday, Sept. 2: No changes or new recommendations.

Friday, Sept. 5: We have three new recommendations:

1. Sell December S&P at the market, risking 257.00, good anytime.
2. We have also an additional recommendation regarding stock indices: Sell one unit of December '86 S&P and buy one unit of December '86 Value Line. Risk the spread widening to 2000 points.
3. We like the short side of T-bonds again. Buy two units of March '87 put options with an 88 strike, hoping to sell half the position on a good-sized dip and recoup your investment; the balance will be retained for a substantial down move. Next regular update: Tuesday, Sept. 9.

Tuesday, Sept. 9: No changes or new recommendations.

Flash update, Wednesday, Sept. 10, 9:45 a.m.: We advise liquidating, at the market, long platinum positions (now trading at 628.00, basis October) and switching over to long gold, thus adding to existing gold positions.

Flash update, Thursday, Sept. 11: Liquidate all outright long positions in SF, DM, and yen at the market. Please note that we are retaining our

long SF/short BP and long DM/short BP cross spreads. Our regular weekly update will be after market hours tomorrow, Friday, Sept. 12.

Friday, Sept. 12: A review of the week's activities and new recommendations. 1. As of our flash update, Wednesday, Sept. 10 at 9:45 a.m., we liquidated our long platinum positions at approximately 628.00, basis October, and advised switching over to long gold, thus adding to our existing gold positions.

2. As of our flash update, Thursday, Sept. 11, we advised liquidating outright long positions in SF, DM, and yen. At the same time we advised retaining long SF/short BP and long DM/short BP cross spreads.

3. We hit the jackpot last Friday on our recommendation to sell the December S&P. To protect substantial profits, lower stops to 236.00, good anytime, basis December.

Tuesday, Sept. 16: No new changes or new recommendations.

Flash update, Sept. 17, 12:00 a.m.: 1. Cover all S&P short positions at the market. Wait for rally to reinstate. Stay posted for reentry recommendation. 2. Reinstate outright long positions in SF and DM but not in Japanese yen.

Friday, Sept. 19: A recap of the week's activities:

1. As of our flash update on Thursday at noon, you have reinstated your outright long positions in SF and DM but not Japanese yen.
2. You were also recommended to cover short S&P positions. Our new recommendation is to reinstate short positions in Dec. S&P at market.

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