FRIEDBERG'S
COMMODITY & CURRENCY COMMENTS

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Bretton Woods II?

A consensus seems to be emerging among the world's central bankers: The dollar has gone about as low as is prudent (Germany et al, Japan) or as low as is necessary (Volcker) or, finally, about as low as would make a difference (IMF). The US Treasury Department may not necessarily share this view, but in recent days Mr. Baker's hardball game appears to have been exhausted.

What is more, the Bank of Japan means business, as the currency portion of international reserves rose, through August, to $41.3 billion, a $13 billion increase since March and its highest level in history. Moreover, little is known about the Bank of Japan's (BOJ) hidden reserves and the increase in gold holdings. (See Dean Taylor, "The Mismanaged Float: Official Intervention by the Industrialized Countries," in *The International Monetary System: Choices of the Future,* ed. Michael B. Connelly, New York: Praeger 1982.) While we still lack August and September figures for West Germany, it is quite conceivable that its international reserves as well as those of other European central banks increased by many billions of dollars in view of the EEC's recent commitment to halt the dollar's slide. It is worthwhile noting that the BOJ intervention began in earnest in July, probably two months earlier than the EEC, a suspicion that is further confirmed by the fact that the yen has traded in an *extremely tight range* since early August (Chart 1), and has depreciated vis à vis the DM (Chart 2).

In the interim, the US trade deficit has not improved and may even have deteriorated for July to show a $15 billion shortfall (after adjustments for unusually large gold exports and oil imports), or an annual rate of $180 billion. Some economists argue that the conventional trade-weighted index does not measure properly the true extent of the devaluation and that in fact it has been much smaller than commonly believed (see "Dollar indexes and trade," which follows). We believe that a dollar depreciation coupled with a credit boom cannot reverse the trade gap for two reasons: First, because income elasticity is a far greater factor in the propensity to import (and export) than price elasticity; second because US trading partners (and we mean to include Canada, Mexico, Brazil, Korea and Hong Kong among others) will not allow a competitive trade weighted *real* depreciation in excess of perhaps 15%.

The only genuine method of *reversing* the US external account is for it to experience a dramatic recession — the classic IMF adjustment prescription so widely used with the Latin American debtors. Moreover, this recession must exceed in depth the recession that is being, and will be, experienced by its main trading partners. At the very least, the US must experience a substantially smaller rate of growth than its trading partners. This "differential growth rate" problem is well understood by Mr. Volcker and not understood at all by Mr. Baker. That is why the former believes that the dollar can stop sliding and the Germans and Japanese must reflate, while the latter keeps shooting from the hip about the value of the dollar.

Ideally, a three to four percentage point differential growth rate in favor of the major trading nations vis à vis the US should do the trick. Unfortunately, the scope for such stupendous growth rate does not exist. Japan is in recession, battered by a rising yen and the collapse of profitability in the export sector. The UK is stagnating, and the rest of Europe is barely limping along with a 2% rate of growth. Only West Germany has shown some resilience, and even then, manufacturers' orders have begun, of late, to look pretty weak. If Germany, the rest of Europe, and Japan can only grow at a combined, measly 1½%-2% per annum, the US *must* bear the full cost of the adjustment by experiencing, at the very least, a 1½-2% contraction.

The US is *hoping* for a vigorous upturn in the industrial-

In this issue

Hotline number

Please note that the telephone number of the Hotline Update will be changed as of the close of business, Friday, October 31, 1986. A separate card showing the new telephone number is enclosed with this issue.

ized world. With this *hope* it tries to pursue domestically a stimulative economic policy. If the rest of the industrialized world does not react, the trade deficit will *widen*, not narrow, and calls for protectionist measures will grow even stronger.

We've gotten ourselves ahead of the story. If the Federal Reserve already accepts the view that the dollar need not go any lower, then stimulative monetary policies are counterproductive in that they are likely to set off a free-falling dollar. And, of course, this leads to rising interest rates and the much-feared adjustment via recession. How, then, to stimulate further monetary growth without risking a dollar collapse?

The answer lies in "massaging" expectations — in playing once more the "greater fool" game. If the Fed were to join the Bundesbank and the BOJ in a joint, explicit declaration of what, *de facto*, is already a fixed-rate currency regime, US money markets will be sent on a euphoric trip, capable of piercing unimaginable yield barriers. The logic would be impeccable: A return to Bretton Woods (that is, fixed rates) means a return to monetary discipline. Global fixed-income traders would jettison DM and yen bonds in favor of higher yielding US debt instruments, since parity will have been assured. For a few months, the financial world would stand mesmerized under the cover of the thick cloud of "uppers"; the Fed and the Treasury would abandon all semblance of discipline in a desperate effort to "reflate" the struggling US economy. The Europeans and Japan would be relieved for having been maimed but spared their lives.

In this not-too-implausible scenario, US financial markets would skyrocket. In due course, the play will be shown to be a smokescreen. At first, US inflation will begin to show up (as it *will*, regardless of this scenario) in the Producer Price Index and then in the CPI. Then, the dollar will come under pressure and an enormous amount of dollars will be absorbed by the intervening central banks to keep to the agreed parities. Since these dollar balances will not be sterilized (as befits the old Bretton Woods semi-gold standard) because the US will not want to tighten money, world money supply will soar... and so will inflation. Finally, either the scheme is abandoned and the dollar is "devalued" further or the day of reckoning comes and the US accepts the recessionary adjustment.

To summarize: The world's three largest currencies have *de facto* been fixed around ¥ 155 and DM2.00 with the active participation of the central banks of Japan and the EEC, and the faint acquiescence of the Fed (the Treasury has dropped its gloves). The *de facto* return to fixed rates has not brought about the benefits of a concerted grand manipulation of the investment world's mindset. Politicians have not, as yet, understood the potential of just such an "agreement." When they do, they will provide the spark for a fabulous run-up in stock and bond prices. It should be noted that in deference to the Treasury, the "deal" may be struck at a slightly lower level, perhaps DM1.85-1.90 and ¥ 150. Be that as it may, "cooperation" will be trumpeted to have triumphed when, in fact, politicians will have bought themselves a little respite and the everlasting gratitude of Wall Street.

STRATEGY: *Over the Hotline we have mused out loud about Bretton Woods II and advised covering outright short positions in stock indexes and T-bond futures (we'll keep, just in case* we *are dreaming, the T-bond puts). We are so convinced that to look good, politicians will grasp at whatever opportunity presents itself — and this one certainly does — that we will suggest a heresy: Buy December '86 Value Line, placing stops at 217, close only. Retain long Value Line/short S&P spread (see Chart 7).*

Long positions in SF, DM, and Japanese yen need not be disturbed. Any attempt to "fix" formally will not *involve a drop in these currencies; more likely, they will stay at these levels. Since there is even a chance that they could be slightly revalued prior to an agreement, we prefer to maintain long positions.*

Chart 1

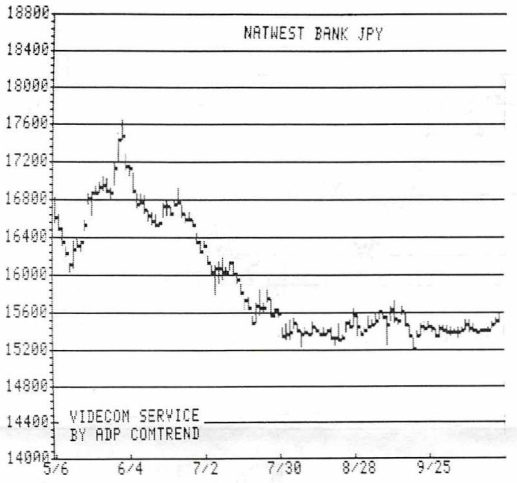


Chart 2

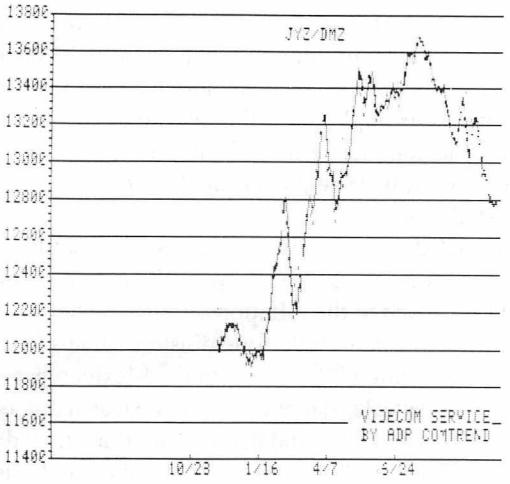
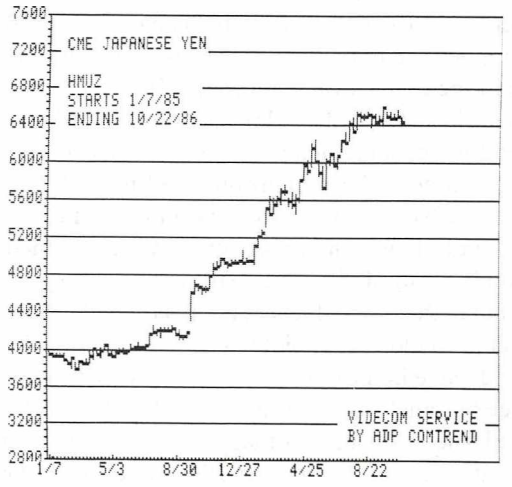


Chart 3



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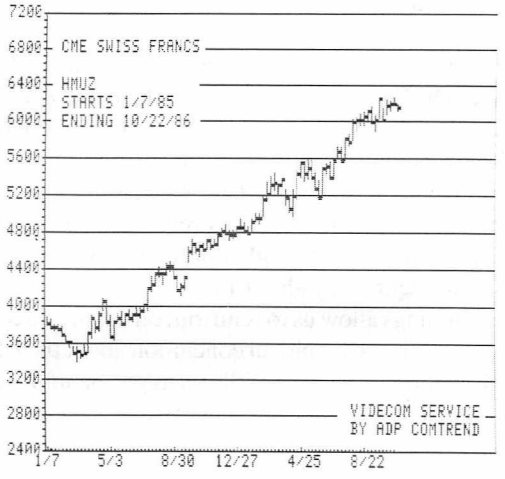
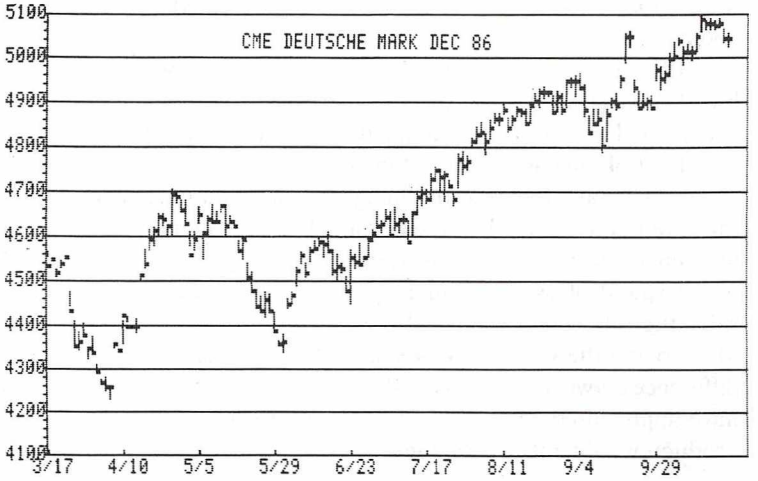


Chart 5



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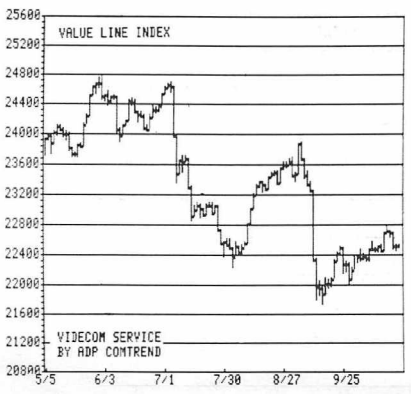

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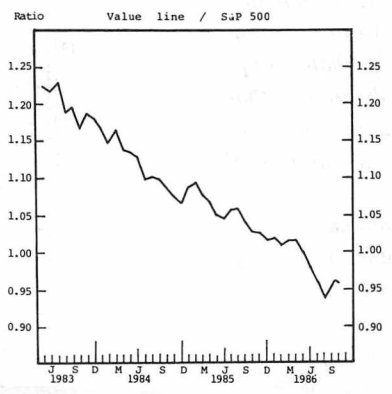
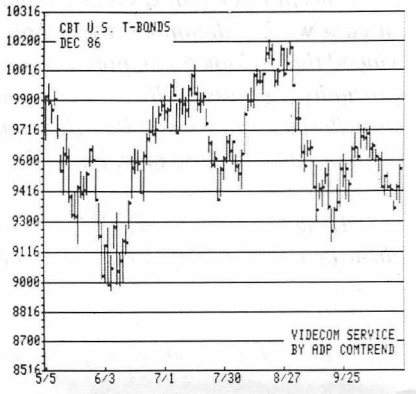


Chart 8



Dollar indexes and trade

In the August 17, 1986, issue of *FC&CC*, we reported that the Federal Reserve Board's "Trade-Weighted US Dollar Index" had fallen 33% from its February 1985 peak. We argued that the Fed's index was of limited value in assessing the effects of changes in the dollar's value on trade. Two limitations concerned us: First, the Fed's index includes only 10 countries and, therefore, excludes many of the US's important trading partners. Secondly, the weights attached to each of the 10 currencies are based on both financial and trade flows, rather than just trade flows. In consequence, we concluded that, from a trade point of view, the Fed's index greatly exaggerates the fall in the dollar. Hence, the US trade deficit cannot be expected to close as rapidly as might be implied by the dramatic decline in the dollar's value on the Fed's index.

Since our analysis of this issue, Dr. W. Michael Cox has developed a new dollar index that addresses both of our concerns. Writing in the September 1986 issue of the Federal Reserve Bank of Dallas' *Economic Review*, Dr. Cox presents his X-131 index. It includes the currencies of US's top 131 trading partners, with each weighted according to trade flows. The results from the X-131 index confirm our analysis: From March 1985 through August 1986, the dollar declined by only about 6%.

This, however, is not the end of the story. After we published our analysis, we received a rebuke from Professor Milton Friedman. He correctly pointed out that to properly evaluate the effect of changes in the value of the dollar on trade, we should not have focused on changes in nominal exchange rates; rather, we (as well as the Fed and Dr. Cox) should have used changes in real, inflation-adjusted exchange rates.

To put Professor Friedman's point into perspective, consider the following example. In 1985, the inflation rates in Mexico and the US were 49.4% and 3.6%, respectively. The difference between them was 45.8%. Hence, if the dollar would have appreciated by 45.8% in nominal terms, US exporters' products would not have become less competitive in Mexico, and trade would have remained unaffected. This result would have been obtained because Mexican firms would have had to incur differential cost increases (the difference between inflation rates in Mexico and the US) that would have been equal to the US export price increases caused by an appreciating dollar. In this example, even though the dollar would have appreciated in nominal terms vis-à-vis the Mexican peso, the dollar rate would have remained unchanged on a real, inflation-adjusted basis.

In 1985, the US dollar actually appreciated by about 105% in nominal terms vis-à-vis the Mexican peso. Since this nominal appreciation exceeded the inflation differential between the two countries, the real, inflation-adjusted value of the dollar increased by about 60% relative to the Mexican peso, and US exporters became less competitive in Mexican markets.

If inflation rates in the US and in countries that we trade with are about the same, then changes in nominal and real exchange rates will be about the same. However, when inflation rates diverge, changes in nominal and real exchange rates will diverge. In fact, they can move in opposite directions. In consequence, we should always use changes in real, inflation-adjusted exchange rates to assess probable changes in trade flows.

Fortunately, we now are able to properly respond to Professor Friedman. Dr. Cox has shared with us the results of an analysis of real, inflation-adjusted exchange rates for 105 countries, which he plans to publish in the near future. (Limited data on inflation rates required that he reduce his sample from 131 to 105 countries.) Dr. Cox's new research shows that from the first quarter of 1985 through March of 1986, the real value of the dollar declined by about 10%.

These new findings allow us to reaffirm, on correct theoretical grounds, our original empirical conclusion about the US trade deficit: It will not close as rapidly as might be implied by the dramatic decline in the dollar's value on the Fed's index.

— Steve H. Hanke

The Fed's faustian bargain

In the September 21, 1986, issue of *FC&CC*, we presented the outlines of an immense build-up of debt in the United States and indicated that this promises to create some severe economic and financial problems. (The April 20, 1986, issue contained a piece about international debt.) We now delve more deeply into the processes that debt expansion has set in motion.

Overindebtedness. The creation of debt involves the exchange of "money today" for "money later." With each new debt instrument, risks are created because lenders give up a certain command over money today in exchange for an uncertain stream of money in the future. To determine whether debt levels are prudent or whether they represent overindebtedness, we must know something about the cash payment commitments due creditors on outstanding financial instruments and the anticipated sources of cash that will be used by debtors to pay creditors.

Debtors fall into one of three financial categories. These financial categories, which were developed by Professor Hyman Minsky, are differentiated by the relation between the contractual payment commitments due on debtors' liabilities and debtors' cash flows. *Hedge financing* represents the first category. An entity is hedge financing if its anticipated cash receipts exceed contractual payment commitments in each payment period. For example, entities that have only equities on the liability side of their balance sheets or whose debts are long-term bonds with sinking fund provisions, where payments to the sinking funds are well within the limits set by anticipated cash flows, are engaged in hedge financing. Entities that hedge finance are not directly susceptible to adversity from changes in financial markets. The only way that these entities can become troubled is if their cash receipts fall short of expectations.

Speculative financing. Entities engage in speculative financing if the total flow of cash receipts exceeds the total payment commitments (interest plus principal), if the cash receipts in each period exceed interest commitments but if cash receipts in some periods (typically near-term periods) fall short of covering both interest plus principal commitments. Speculative financing involves the short-term financing of long-term positions and requires maturing debt to be rolled over. Entities that are engaged in this type of finance — for example, commercial banks — are speculating that they will be able to roll over short-term obligations on favorable terms. In consequence, speculative financing entities are directly vulnerable to adverse changes in the financial markets. For example, savings and loan associations became severely distressed in the 1979-1982 period because short-term rates on liabilities, which were used to finance long-term assets, rose dramatically.

Ponzi financing. Ponzi financing entities are speculative financing entities with the special characteristic that, for some, if not all, of the near-term periods, cash receipts aren't great enough to cover interest commitments. Hence, these entities must increase their outstanding debt just to pay interest, and interest must be capitalized into their liability structures. Needless to say, Ponzi financing leaves those who engage in it most exposed to adverse changes in financial markets.

The potential for economic and financial instability increases as the balance of total debt shifts from the hedge financing to the Ponzi financing end of the spectrum. To put it another way, as an economy moves away from hedge financing toward more speculative and Ponzi financing, margins of safety are squeezed away and indebtedness becomes overindebtedness.

That overindebtedness exists should be clear from a review of the materials presented in the April 20 and September 21, 1986, issues of *FC&CC*. However, it is important to recall that in the past many corporate bond issues carried sinking fund provisions. Now, these are virtually extinct. Instead, junk bond finance and leveraging are at the cutting edge of corporate finance. The nature of Less Developed Countries' (LDCs) debt also has been radically transformed. In the past, LDC loans were typically made to private entities that were exposed to bankruptcy courts and, as a loan condition, pledged collateral. Now, 85% of the LDC loans are made to governments. These loans represent unenforceable claims that, in most cases, are pure Ponzi financing schemes.

Overindebtedness and deflation

As business cycle recoveries mature, overindebtedness invariably raises its head. Professor Irving Fisher was the first to integrate overindebtedness into a business cycle theory. His 1932 book, *Booms and Depressions*, is devoted to an exposition of the cyclical dynamics of overindebtedness and to its application in explaining the Great Depression. A Fisherian business cycle peaks with unsustainable overindebtedness. This triggers a downward plunge, which is tied together by the following linked process:

1. Debt liquidation leads to distress selling and to
2. A contraction in demand deposits, as loans are paid off, and to a slowing down in the velocity of money circulation. This causes
3. A fall in the level of prices, which leads to
4. A still greater fall in the net worths of businesses, which precipitates bankruptcies and
5. A fall in profits, often resulting in losses, which leads to
6. A reduction in output, in trade and employment. These losses, bankruptcies and unemployment lead to
7. Pessimism and a loss in confidence, which in turn lead to
8. Hoarding and further reductions in the velocity of money circulation.

While the Fisherian cycle is triggered on its downward spiral by overindebtedness, it is important to recognize that the economy continues to move deeper into a depression and

deflation because the money supply and its velocity are declining. Hence, Professor Fisher's theory is both an overindebtedness and a monetary theory of the business cycle.

Even though we don't have a quarrel with Professor Fisher's logic or with his explanation of the Great Depression, we must question the strict adherence to his original model in today's environment. After all, we have had five episodes of financial trauma in the past 20 years: 1966-67; 1970; 1974-75; 1979; and 1981-82. Each of these was triggered by overindebtedness, and each resulted in considerable economic and financial turmoil. However, widespread distress selling, which depresses asset prices, and a prolonged decline in profits, which increases the burden of debt, were avoided. We must ask: Why has a full-blown debt deflation not occurred?

Overindebtedness and inflation

To answer the last question, we must examine the contemporary policy responses to the economic and financial problems that have been triggered by overindebtedness. Once overindebtedness triggers the Fisherian debt deflation process, we can reduce, for purposes of simplicity and exposition, the process to two critical aspects: the course of profits (uncommitted cash receipts) and the availability of refinancing on favorable terms. Let's look at how contemporary policy interventions influence each and act to abort debt deflations.

The first intervention involves fiscal policy. As the debt deflation process is triggered and the economy begins to falter, the flow of tax receipts begins to slow and the pace of government transfer payments increases; government deficits increase. Loose fiscal policy tends to keep consumer spending rolling, and this acts to prop up profits and break up the Fisherian debt deflation process. This, in part, explains why strong consumer spending typically leads economic recoveries. (Our record fiscal deficits explain why consumer spending has provided most of the fuel for the current expansion.)

The second intervention involves monetary policy. Overindebtedness and its triggering of the debt deflation process creates a financial crisis that has as its focus one or several institutions or markets in which the inability to make payment commitments first occurs. (At present, agriculture, energy, commercial real estate, and LDC loans qualify.) The inability of debtors to meet payments on these liabilities is typically contained by some form of concessionary finance by the monetary authorities. This acts to break up the debt deflation process.

Traditionally, bank exposure to risk was constrained, however imperfectly, by customer surveillance. In the days when depositors incurred losses as banks failed, customers viewed any increases in the leverage of bank portfolios and consequent increases in risks with displeasure. This acted to create prudent bankers. Now, however, the rules of the game have been changed. With the explicit guarantee of deposits by the Federal Deposit Insurance Corporation and the further implicit guarantees of the Fed to "manage" bank failures, nonequity liabilities of almost all "failing" banks have been validated. In consequence, customers have fewer incentives to monitor banks' exposure to risk. Not surprisingly, banks, in their drive to increase yields on equity, have increased their leverage and exposure to risks. Leverage has, therefore, become critical to the maintenance of bank yields on equity.

As debt liquidation begins in the Fisherian process, the banks' leverage is reduced. To maintain leverage and profits, banks react by using funds from liquidated loans to increase their holdings of government securities. In addition, and more importantly, the Fed loosens credit, so that banks have free reserves. This allows banks to further add to their holdings of government securities and maintain leverage. In consequence, the money supply, contrary to Professor Fisher's analysis, fails to contract with debt liquidation. Instead, the money supply expands.

This infusion of reserves by the Fed — an intervention intended to prop up banks and protect depositors — breaks the debt deflation process and ultimately leads to an explosion in credit that is incompatible with noninflationary economic growth. Banks, therefore, are at the center of the disruptive influences that force the Fed to engage in excessive monetary creation.

By incorporating modern policy responses into Professor Fisher's analysis, we find his cycle theory just as powerful as it was in 1932. The only thing that is altered is his conclusion: Instead of leading to deflation, overindebtedness leads to inflation.

The current situation

At present, fiscal policy is about as loose as any prudent observer could imagine. In consequence, the full weight of aborting a Fisherian debt deflation has been placed on the back of the Fed. This explains why the Fed has been forced to accept a Faustian bargain: Over the past two years the Fed has moved away from targeting money supply growth, as well as other targets: instead, the Fed appears to have embraced a random walk monetary standard.

The results are all too predictable. The money supply is exploding, and bank reserves are growing. Banks also are shifting their portfolios away from private loans and towards investments in securities, particularly those issued by the US government. It is only a matter of time before this random walk approach to monetary policy produces inflation that will startle most observers.

STRATEGY: *With our views about inflation, we remain steadfast bulls on gold. Gold represents the centerpiece of our portfolio, and promises to be the best inflation play of the coming year.*

— Steve H. Hanke

Crude shenanigans

For 16 days, Opec ministers struggled to reach an accord. The powerful Gulf bloc, led by Kuwait, insisted on a low overall production ceiling and a significant redistribution of quotas towards their countries as compensation for the "many years of sacrifices" spent in the effort to make Opec a successful cartel.

Having been unsuccessful in cartelizing world production (in view of the British rebuff and the miserly concessions advanced by Norway and Mexico), the Gulf states turned their attention to the terrorized "other" members of Opec. Not only would the Saudis not play the role of swing producer but they also would begin insisting on larger internal quotas. For political reasons, Kuwait — the most profitable and solvent Opec member (see "Kuwaiti dinar" under "The Exotics") — was put up to raise the issue. It insisted on an additional 90,000 barrels per day (b/d) quota, 10% of its present quota of 900,000 b/d. After much haggling (and drama), the Saudis engineered a compromise: Opec would raise its overall ceiling by 200,000 b/d, and Kuwait would receive 45% of the increase (see Chart 9). Only Saudi Arabia, the UAE, and Iraq were not granted increases. However, the Saudis got Opec to accept the fact that the 300,000 b/d that Saudi Arabia and Kuwait have been producing from their shared neutral zone as "war relief," or a form of aid to Iraq to sustain it in its conflict with Iran, *will henceforth be counted as part of Iraq's quota.* And Iraq has no formal quota, although it is able to produce at least 2 million b/d. Finally, the UAE is known to be overproducing by at least 300,000 b/d. In all, barring any further serious instance of cheating, Opec will be producing 17.5 million b/d by early December.

According to the International Energy Agency's latest estimate, crude oil stocks in the 22 industrialized states making up the OECD rose at a rate of 1.2 million b/d in the second quarter of 1986 and at least 1.6 million b/d in the third quarter of 1986 (figures that will be revised upwards once the volume at long haul oil lifted in late August is known). Inventories in OECD member countries are estimated to have totalled 440 million tonnes on October 1, compared with 416 million tonnes a year earlier. They amounted to *a very ample 96 days of forward supplies.* These figures are confirmed by US trends as reported by the API weekly reports, which show that US crude stocks have increased better than 6% over last year. What the IEA *does not* estimate is the stock of oil *products.* If the API is an approximate proxy for worldwide trends, product stocks are unusually high: In the US, distillates are 33 million barrels above a year earlier (a whopping 28% increase!), while gasoline is almost 10 million barrels above a year earlier (4.5% higher).

Given the Gulf states' insistence on a "fairer" realignment of quotas, to be resolved once and for all and on a permanent basis in December, it would be ingenuous to believe that the present make-shift output ceiling will be respected much longer. If 17 million b/d becomes, then, an *output floor* as we believe it will be, then oil users and consumers will want to draw down their excess stock as quickly as possible. Since the build-up amounted to at least 1.6 million b/d *for about half a year* and winter demand for Opec crude may not exceed 16.5 million b/d (after taking into account growing non-Opec supplies), real demand for Opec crude may not exceed 13-13.5 million b/d. The production surplus will bear on prices in much the same way as it did in late 1985/ early 1986 — and prices will, once again, be cut in half.

The oil producing nations are trapped in a long-term bear market from which there is no escape. The grim reality is that only a very lengthy period of very low prices can restore demand and shut-in marginal production. The enormous advances in technology have lowered, and will continue to lower, beyond imagination, marginal costs of production while opportunistic taxes, levied by hungry governments will impede a more normal consumption response to low prices.

Gloating bears, however, must still contend with a now more remote possibility of an Iranian military victory. Should it happen, it will merely force a temporary detour in this long path to much lower prices.

STRATEGY: *Add to short positions. Cover only if there are* reliable *indications that Bashra has fallen to the Iranians.*

Chart 9

OFFICIAL OPEC QUOTA LIST
Barrels Per Day

	New Quotas	Previous Quotas
Algeria	669,000	663,000
Ecuador	221,000	183,000
Gabon	160,000	137,000
Indonesia	1,193,000	1,189,000
Iran	2,317,000	2,300,000
Nigeria	1,304,000	1,300,000
Qatar	300,000	280,000
Saudi Arabia	4,353,000	4,353,000
United Arab Emi.	950,000	950,000
Venezuela	1,574,000	1,555,000
Libya	999,000	990,000
Kuwait	921,000 (Nov)	
	999,000 (Dec)	900,000

Iraq, capable of producing up to two mln BPD, was excluded from limitations on its output as in the OPEC accord for September and October)

The total, excluding Iraq, is 14,961 mln BPD in November and 15,039 mln BPD in December, averaging 15 mln BPD.

Chart 10

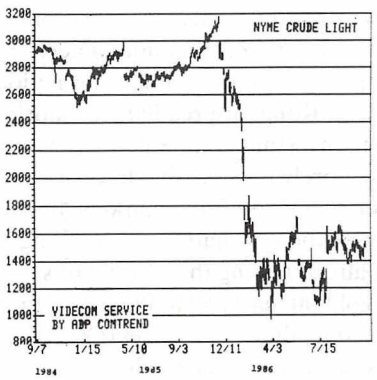


Chart 11

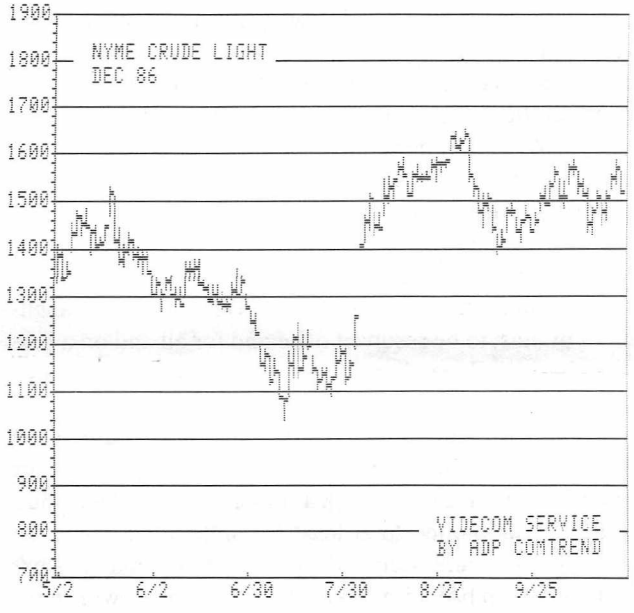
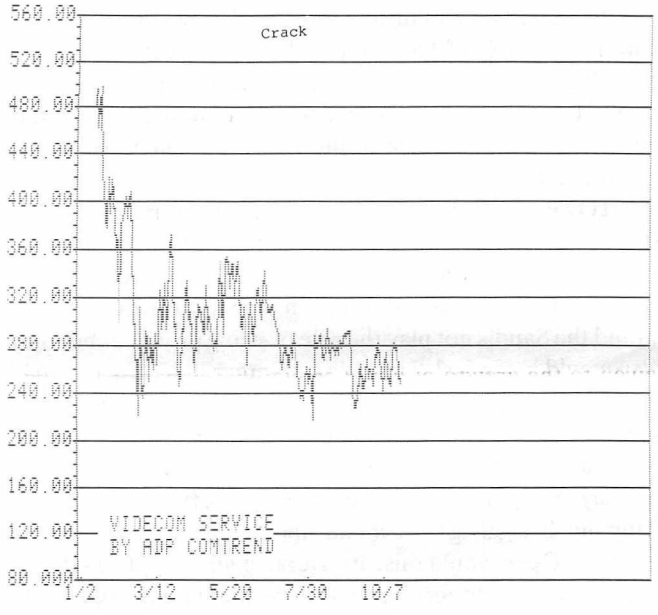


Chart 12



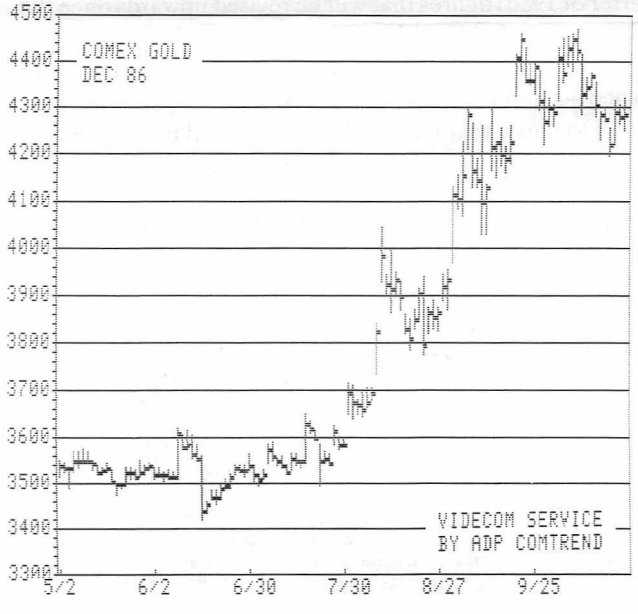
Gold

The skeptics abound, a wonderful sign of this market's youthfulness. No less an authority than George Milling-Stanley, the author of the now widely acclaimed Consolidated Gold Fields annual report, believes that the recent flood of sales by mid- and far-Eastern hoarders since the metal moved through $380/oz. will put a definite lid on the market. He also believes that the Soviet Union and China, pressured by foreign exchange problems, will increase the pace of their sales this year by a few hundred tonnes. Finally, he believes that the West's production will reach about 1,400 tonnes by 1990, up substantially over last year's estimated total production of 1,213 tonnes. He concedes that Western hoarders will be buying increasing amounts of gold as Western attitudes change but dishoarding by Eastern holders is likely to offset this shift in portfolio preferences.

We disagree rather strongly. Coin sales in the US alone are likely to exceed 5 million ounces (160 tonnes, or 13% of world primary production); other nations (Australia, Brazil, and Hong Kong) are readying to satisfy what seems to be a growing investment appetite for small gold coins. Finally, it seems entirely possible that foreign central banks will decide to intervene in the forex markets, buying up dollars and disposing of these dollars by purchasing gold. Is the Bank of Japan already doing this? Could this be why they bought far more gold (at least 350 tonnes) than required to mint the Hirohito coin (about 200 tonnes)? We are convinced that this is more than a passing coincidence.

STRATEGY: *After advancing almost uninterruptedly from the mid-June lows of $340/oz., gold is taking a deserved pause. We remain extremely bullish and believe that it is only a matter of (little) time before new, historic, alltime highs are seen. Add to positions on 5%-10% setbacks from any high.*

Chart 13



Currencies

Short Sterling/ Long DM or SF

On October 10 we suggested taking partial profits on this most wonderful trade. We were anticipating that the Chancellor of the Exchequer would deliver a rather stern warning to Sterling bears after seeing the cross rate slide to a new alltime low of DM2.82. Mr. Lawson contented himself to point out that credit conditions had not grown excessively if due consideration is given to the growth of liquid assets; that, yes, it is true that M0 had grown a bit faster than desirable, indicating an easing of monetary conditions and justifying a slight 1 percentage point increase in interest rates; and that it was natural for Sterling to fall to enable non-oil exports to rise and thus offset the precipitate collapse of oil prices.

A bland, very bland speech considering that Sterling had dropped nearly 16% since late summer (see Charts 14 and 15). Also a vindication of our view that the Thatcher government may have already chosen the deliberate path of currency depreciation to revive the stagnating, high-unemployment economy before the upcoming elections. Subsequent to his speech, we advised reinstating the full original position.

STRATEGY: *Maintain spread; add on rallies to a DM/Sterling 3.00 cross-rate.*

Chart 14

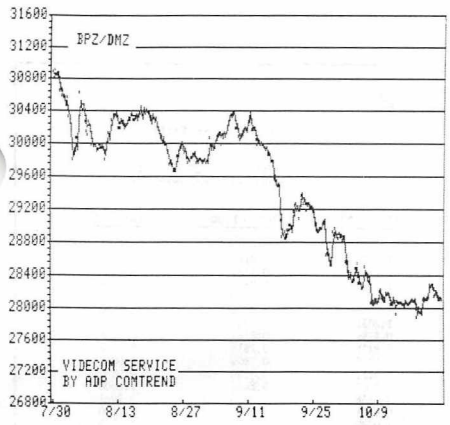


Chart 15

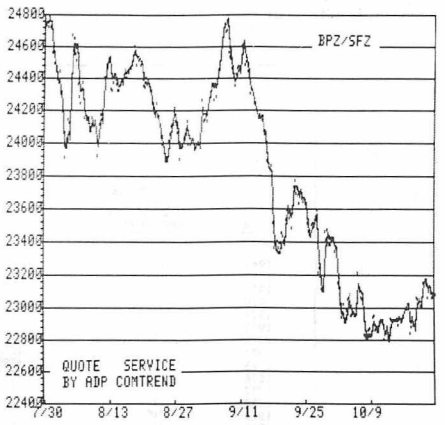
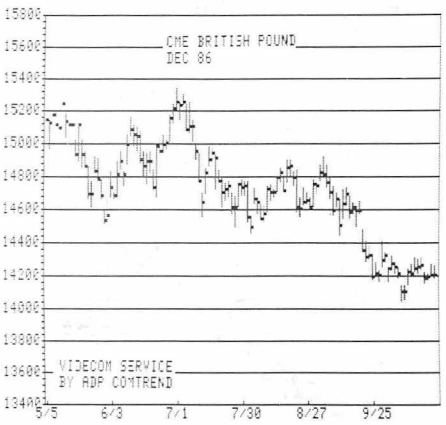


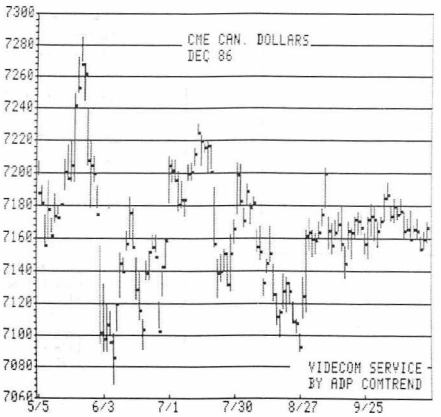
Chart 16



Canadian dollar

STRATEGY: *Remain short.*

Chart 17



The Exotics

Singapore dollar

The barrage of Keynesian fiscal measures adopted in February of this year had the effect of cushioning the fall in GNP towards the second quarter of 1986. As a result, the annualized 3.4% slide in the first quarter of 1986 has turned into a flat or perhaps, slightly positive, number in the subsequent quarters. The government measures added more than $2.8 billion to the economy, or roughly 7.5% of GNP — a very substantial one-shot injection by any standards.

While some of the measures, such as the 15% cut for employees contribution to the Central Provident Fund, the cut in the corporate tax to 33% from 40%, and an across-the-board 25% rebate for personal income tax, were laudable, the overall impact on government finances is devastating as long as it refuses to cut expenditures. And so government deficit as a percentage of GNP for 1986 will approach 20%, a banana republic level. Domestic government debt will exceed GNP for the first time ever. Moreover, the temporary adrenaline injection may be reversed towards the end of 1986, as the government increases consumption taxes.

From our vantage point, it would appear that the government ought to dramatically slash spending and allow the Singapore dollar to float downwards to regain international competitiveness and cause a *genuine* recovery in the economy via the external sector. The trade deficit has been narrowing for the past four years, moving from minus US$6.7 billion to an expected minus US$2.9 billion. However, it would be logical to see a "leaner" Singapore experience a trade surplus. But that result seems to be still a long way off.

STRATEGY: *Sell Singapore dollar against both the DM and US dollar. Place stops at 2.1400, basis spot, against the US dollar and 4.2700 against the DM.*

Chart 18

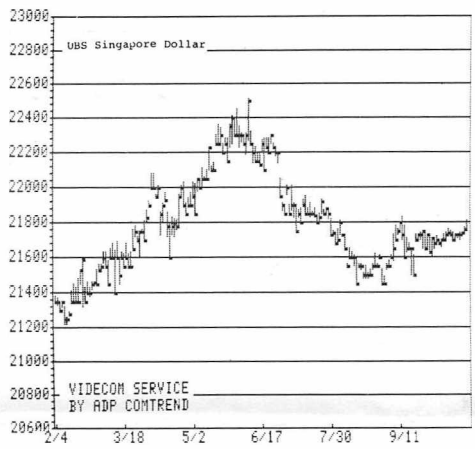


Chart 19

YEAR	SINGAPORE DOLLAR PER U.S. DOLLAR (PERIOD AVG.)	U.S. 1970 =1.00	U.S. 1977 =1.00	BASKET 1970 =1.00	BASKET 1977 =1.00
				U.S. 23% JAPAN 29%	
				MALAYSIA 31% U.K. 6%	
				Germany 5% AUSTRALIA 6%	
1967	3.0804	0.8624	1.1071	0.9189	1.0611
1968	3.0796	0.8933	1.1468	0.9162	1.0580
1969	3.0788	0.9435	1.2112	0.9522	1.0996
1970	3.0946	1.0000	1.2838	1.0000	1.1547
1971	3.0342	1.0052	1.2904	1.0191	1.1768
1972	2.8125	0.9415	1.2087	0.9899	1.1431
1973	2.4574	0.7311	0.9385	0.8184	0.9451
1974	2.4368	0.6571	0.8436	0.7515	0.8678
1975	2.3713	0.6799	0.8728	0.7809	0.9017
1976	2.4708	0.7642	0.9811	0.8350	0.9642
1977	2.4394	0.7790	1.0000	0.8660	1.0000
1978	2.2740	0.7453	0.9568	0.8600	0.9931
1979	2.1746	0.7627	0.9791	0.9006	1.0400
1980	2.1412	0.7859	1.0089	0.9395	1.0849
1981	2.1127	0.7905	1.0148	0.8892	1.0268
1982	2.1400	0.8183	1.0505	0.8873	1.0246
1983	2.1131	0.8240	1.0578	0.8700	1.0046
1984	2.1331	0.8453	1.0852	0.8644	0.9981
1985	2.2002	0.8985	1.1534	0.8941	1.0325
1986 (1Q)	2.1433	0.8946	1.1485	0.9165	1.0583
1986 (2Q)	2.2090	0.9279	1.1913	0.9536	1.1012

Above 1.00 = Undervalued
Below 1.00 = Overvalued

Chart 20

Year	Foreign Assets (Mln US$)	CURRENT ACCOUNT As % of GNP %	CUMULATIVE 12 QTR. Current Account (Mln US$)
1970	1050	-30.2	- 896
1971	1320	-32.2	-1487
1972	1525	-17.1	-1791
1973	1841	-12.7	-1738
1974	2466	-20.3	-2035
1975	2770	-10.3	-2124
1976	2983	- 9.7	-2172
1977	3351	- 4.5	-1446
1978	3511	- 5.8	-1315
1979	5177	- 7.8	-1484
1980	5684	-13.8	-2696
1981	6197	-10.5	-3621
1982	6843	- 8.3	-4091
1983	6118	- 5.0	-3403
1984	6810	- 4.2	-2752
1985	9468	- 1.5	-1799
1986 (1)	9140	-	-

Chart 21

HARD CURRENCY COVER (In millions of U.S. Dollars)
Reserves * + Previous 12-months curren Account *** = 12443
(Reserves + 12-months C/A) /M1 ** = 12443/4038 = 308%
(Reserves + 12-months C/A)/ Broad Money ** = 12443/12857 = 97%
*As at Feb. 1986** March '86 *** 1986 Estimated

Figures in millions of U.S. Dollars

	M1 (Converted to U.S. Dollars)	Broad Money (Converted to U.S. Dollars)
1976	1629	3747
1986 (March)	4038	12857
% Increase (decrease)	148%	243%
Corresponding % increase in the United States	98.2%	115.5%

(a) 1985 Imports as percentage of GNP 144.8%
(b) 1976 - 1985 Imports as percentage of GNP 167.3%
1985 /1976 - 1985 average) = (a)/(b) = 86.5%

Source: IFS

Chart 22

RATES	SPOT	1 MONTH	3 MONTH	6 MONTH	12 MONTH
	2.1780 - 2.1790	2.1722- 2.1737	2.1623- 2.1640	2.1505- 2.1525	2.1380- 2.1490

Kuwaiti dinar

The economy seems to have stabilized at a very low level of output, with GNP showing no growth for the past three years after a net 7%-8% drop in the preceeding two years. The country's oil output rose significantly in the March-August period, averaging 1.45 million barrels per day (b/d), a 25% increase over the 1985 average. In September, Kuwait lowered production to 900,000 b/d in accord with the Opec agreement reached in early August. It is likely that for the year as a whole Kuwait will produce an average of 1.25 million b/d, or about 9% more than in 1985. Prices, however, will be down substantially compared to 1985, perhaps by at least 55%.

Kuwait will manage, however, to record another trade surplus as investment income covers almost two thirds of the cost of imports. In fact, Kuwait will remain in external surplus even if oil averaged $10 dollars per barrel for the entire year. But it is likely that at those levels, Opec's quota system will have gone by the boards and Kuwait's exports will have risen by as much as 50% as we saw last July. In short, their external position is impregnable, at least for the foreseeable future.

There are, however, other considerations: The country's need to diversify away from oil to create employment and the deleterious effect that ongoing deflation is having on the value of collateral behind loans in an already shaky banking system (at least two thirds of the banking system's $14.4 billion in loans is nonperforming). We therefore believe that the monetary authorities of Kuwait will allow for a very *gradual* trade weighted depreciation of the dinar.

STRATEGY: *We've shown a significant profit in our long DM/short KD position. Retain this position and remain neutral against the dollar.*

Chart 23

BASKET: U.S. 10% JAPAN 34% Germany 9% SINGAPORE 7% NETHERLANDS 11% ITALY 21% UK 8%

YEAR	KUWAITI DINAR PER U.S. DOLLAR (PERIOD AVG)	U.S. 1972 =1.00	U.S. 1978 =1.00	1972=1.00	1978 =1.00
1972	0.3282	1.0000	1.2768	1.0000	1.1544
1973	0.2960	0.8827	1.1270	0.9323	1.0763
1974	0.2931	0.8594	1.0973	0.9067	1.0467
1975	0.2900	0.8563	1.0933	0.9092	1.0496
1976	0.2924	0.8686	1.1090	0.9119	1.0528
1977	0.2865	0.8244	1.0526	0.8810	1.0170
1978	0.2750	0.7832	1.0000	0.8662	1.0000
1979	0.2762	0.8180	1.0444	0.9116	1.0523
1980	0.2703	0.8496	1.0847	0.9254	1.0683
1981	0.2787	0.9004	1.1497	0.8961	1.0345
1982	0.2879	0.9157	1.1691	0.8909	1.0284
1983	0.2915	0.9137	1.1667	0.8824	1.0187
1984	0.2960	0.9568	1.2216	0.8986	1.0374
1985	0.3007	0.9912	1.2656	0.9218	1.0642
1986 (1Q)	0.2865	0.9499	1.2129	0.9362	1.0807
1986 (2Q)	0.2914	0.9670	1.2347	0.9651	1.1142

Above 1.00 = Undervalued
Below 1.00 = Overvalued

Chart 24

Year	Foreign Assets (Mln US$)	CURRENT ACCOUNT As % of GNP %	CUMULATIVE 12 QTR. Current Account (Mln US$)
1975	3,154	46.3	-
1976	3,128	45.9	-
1977	4,373	28.6	17,414
1978	4,866	33.8	17,616
1979	5,191	51.0	24,719
1980	6,744	47.2	35,463
1981	7,625	43.2	43,112
1982	8,468	18.4	33,953
1983	7,820	19.8	23,941
1984	7,726	23.5	16,452
1985	8,473	21.4	17,195
1986 (1)	7,750	-	-
1986 (2)	8,772	-	-

Chart 25

HARD CURRENCY COVER (In millions of U.S. Dollars)
Reserves * + Previous 12-months curren Account ***= 10013
(Reserves + 12-months C/A) /M1 ** = 10013/3395 =195%
(Reserves + 12-months C/A)/ Broad Money ** = 10013/15122=66%
*As at June 1986 ** June 1986 *** 1986 Estimated

Figures in millions of U.S. Dollars

	M1 (Converted to U.S. Dollars)	Broad Money (Converted to U.S. Dollars)
1976	1372	4252
1986 (June)	3395	15122
% Increase (decrease)	145%	255%
Corresponding % increase in the United States	110%	122%

(a) 1985 Imports as percentage of GNP 21.0
(b) 1976 - 1985 Imports as percentage of GNP 23.4
1985 /1976 - 1985 average) = (a)/(b) = 89.7%

Source: IFS

Chart 26

RATES	SPOT	1 MONTH	3 MONTH	6 MONTH	12 MONTH
	.29205-	.29226-	.29280	.29350 -	.29420
	.29215	.29249	.29328	.29432	.29570

Forex Rates & Update

Currency	*Spot*	*3-Month*	*12-Month*	*Comments vis à vis US$*	*Comments vis à vis DM (Spot DM 1.9830)*
Australian dollar	.6375-.6380	.6209-.6218	.5835-.5850	Remain long	Remain long
Belgian franc	41.20-41.25	41.32-41.40	41.62-41.77	Remain long	Remain long
Danish krone	7.4725-7.4775	7.5265-7.5365	7.6925-7.7175	Neutral	Remain short
Dutch guilder	2.2450-2.2460	2.2413-2.2426	2.2265-2.2290	Remain long	Remain long
Greek drachma	134.25-134.35	140.95-144.05	158.25-168.35	Neutral	Remain short
Italian lira	1375-1376	1377-1379	1381-1384	Remain long	Neutral
Malaysian ringgit	2.6260-2.6280	2.6585-2.6705	2.7160-2.8170	Neutral	Neutral
New Zealand dollar	.5040-.5055	.4917-.4942	.4620-.4675	Remain long	Remain long
Norwegian krone	7.3000-7.3050	7.4580-7.4670	7.8670-7.8820	Remain long	Neutral
Portugese escudo	145.70-146.00	148.70-150.50	152.20-164.00	Neutral	Neutral
Saudi Arabian riyal	3.7500-3.7510	3.7570-3.7605	3.7925-3.8025	Remain short	Remain short
Spanish peseta	132.60-132.70	134.40-134.70	138.80-139.60	Neutral	Neutral
Swedish krona	6.8425-6.8475	6.8825-6.8905	6.9815-6.9965	Remain long	Neutral
Venezuelan bolivar	23.15-23.35	24.00-25.40	25.00-25.75	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, Sept. 23: No changes or new recommendations.

Flash update, Thursday, Sept. 25, 9:55 a.m.: Having been stopped out of Dec. S&P short position at 23600 as per our recommendation of Friday, Sept. 19, we advise reinstating once again the short position at market (now trading at approximately 235.50). Place new stops at 237.50, basis Dec., good anytime.

Friday, Sept. 26: As of our flash update yesterday, Thursday, Sept. 25, we are once again short the Dec. S&P at approximately 235.50 with a stop of 237.50, basis Dec., good anytime. No other changes or recommendations. The market letter is in the mail.

Tuesday, Sept. 30: No new changes or new recommendations.

Flash update, Tuesday, Oct. 2, 1:45 p.m.: Cover all short positions in stock market futures at the market (approximately 233.50).

Friday, Oct. 3: The only change we made this week was covering the S&P short position as per our Hotline Update of Thursday, Oct. 2, 1:45 p.m. at approximately 233.50.

We are uncomfortable with the fact that despite substantial discounts, the market is unable to make further downward progress. Furthermore, we suspect that behind the scenes a major revision of our international floating foreign exchange system is being planned. The possibility of a return to a Bretton Woods fixed-rate regime, although clearly not a viable alternative given the disparity of present fiscal and monetary policies, is likely to be extremely bullish for the financial markets. These thoughts do not, we repeat, do not lead us to change our forex nor our gold positions. They *do* mean that we are far more comfortable being sidelined in outright stock and bond contracts, at least for now.

Tuesday, Oct. 7: Due to the importance of our message on Friday, Oct. 3, I will repeat it verbatim (see above).

Friday, Oct. 10: There were no changes made during the week. On Tuesday, Oct. 7, we repeated last week's message urging clients to cover all outright short positions in S&P futures and T-bonds (although, for the most part, our short positions in T-bonds was done through the purchase of March '88 put options; leave these options in place.) We now have one new recommendation. We advise liquidating half our short BP/long SF or DM cross-trades, realizing very sizable profits.

Tuesday, Oct. 14: There are no new changes or recommendations.

Friday, Oct. 17: Last Friday, Oct. 10, we advised taking profits on half of our short BP/long SF or DM cross-trades. We now advise reinstating the full position, as we believe that Mr. Lawson is content with the ongoing depreciation of Sterling.

Tuesday, Oct. 21: There are no new changes or recommendations.

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