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A riyal dilemma

King Fahd of Saudi Arabia faces a real dilemma: On the one hand, if the Kingdom pursues a policy that props up oil prices at \$18 per barrel, its oil revenues will fall; on the other hand, if the Kingdom pursues a policy that maximizes the present value of its oil resources, oil prices will fall, the Kingdom's market share will increase, and the Saudis will face political and security problems, which will be generated by the increasingly ruthless Islamic revolutionary regime of Ayatollah Ruhollah Khomeini.

To grasp the nature of King Fahd's dilemma, we must focus on the fundamentals of the world oil market. Let's begin by recalling the outlines of our analysis of November 1985, before the unravelling of OPEC (See: *FC&CC*, Nov. 17, 1985). Excess capacity became the Achilles heel of the OPEC "cartel." To set artificially high prices, OPEC had to initially reduce its output. This left the cartel with initial excess capacity. Once the artificially high prices were set, market forces began to take hold. In consequence, the world's demand for oil began to drop, falling by 15% from 1979 through 1985, and the supply of non-OPEC oil began to rise, increasing by 48% from 1973 through 1985. These market dynamics meant that to maintain artificially high prices, OPEC had to dramatically reduce its output (from its peak in 1977, OPEC output fell by 49%). This, of course, left OPEC with even more excess capacity than it had begun with.

The reductions in output and consequent excess capacity were not evenly spread among the OPEC members. Like non-OPEC producers, many OPEC members found high prices tempting. In consequence, these members developed a propensity for cheating. This left the primary burden of cutting OPEC output with the Saudis. Hence, they became known as the swing producer. As a result, the Kingdom's output fell by 80% from its 1980 peak to August 1985. The Saudis couldn't continue on this course. By November 1985, it was clear that the Kingdom's revenue requirements would force it to increase oil production.

To predict the resulting fall in oil prices, we developed a simple demand model and presented the empirical results derived from it (see Chart 1). This demand model performed well. In June, July, and August, world crude production ranged, on a monthly basis, between about 62 and 63 million barrels per day (b/d). Prices during that period ranged from about \$7

to \$11 per barrel. Chart 1 shows that with a demand elasticity of 0.1 (which we thought was the most realistic assumption), our model predicted a price range of \$7.36 to \$8.63 per barrel. Needless to say, the model has proven to be reasonably well calibrated at a demand elasticity of 0.1. Hence, we will use it (with a demand elasticity of 0.15) to analyze King Fahd's dilemma.

First, assume that the main pricing committee of OPEC, which is currently meeting in Quito, Ecuador, will recommend that OPEC move back to its old system of posted prices, and that the price be posted at \$18 per barrel (This shouldn't be confused with a realized market price.) Further, assume that these recommendations will be accepted at the full meeting of OPEC, which begins on Dec. 11, 1986.

At this point, it appears that these assumptions are realistic because, among other things, King Fahd has indicated that he wishes to reverse the policies instituted in December 1985 by Sheik Ahmed Zaki Yamani, the former Saudi oil minister who was dismissed in October 1986, after 24 years of service. In addition, we should mention that there is a certain short-run logic to the King's support of a posted price of \$18 per barrel. First, it tends to allow the market to be temporarily "talked up." Thus, it prevents, for the time being, a continued free fall of oil prices. Second, it temporarily gets the Iranians off the King's back. Third, it allows the Saudis to present a budget. Recall that the Kingdom's 1986-1987 budget has already been postponed twice this year. Without posted oil prices, the Saudis have been reluctant to publish a budget because it would necessitate a forecast of oil prices, which would require that the Saudis reveal their oil output plans. This problem is avoided under a posted price system, since an "official" posted price can be used for budgeting purposes, without embarrassment or revelation of strategic oil output plans. We anticipate that the long-awaited budget

In this issue

The unrelenting trade gap persuades us to remain long SF and DM. The formidable puzzle of high-priced takeovers, and what it all means for our long Value Line/short S&P spread. And bear markets continue in both British pound and Canadian dollar. Contributions by Albert D. Friedberg, Steve H. Hanke, and Daniel A. Gordon.

for the fiscal year that begins on Dec. 21 will be unveiled at the Saudi cabinet meeting on Dec. 15. Hence, it would seem logical that the Saudis would find an agreement about a posted price of \$18 per barrel to be a convenient outcome from the OPEC meeting that begins on Dec. 11.

But, it's one thing to post a price, and it's another actually to sell oil at such a price. Assume that all the OPEC members, with the exception of the Saudis, produce at their current quota levels, with no cheating (given the desperate revenue needs of many OPEC producers, this "no cheating" assumption is rather heroic). Then, in order for OPEC actually to sell oil at the posted price, the Saudis would be forced once again to become the big swing producer. To hold the market price at the posted level of \$18 per barrel, the Saudis would have to cut their output to 2.48 million b/d from its current level of 4.353 million b/d. This 43% cut in daily Saudi output would increase per barrel prices by about 24%, to \$18 per barrel. Since the Saudi's relative price gain per barrel would be more than offset by a relative decline in output, the Kingdom's oil revenues would fall from their current annualized rate of about \$23 to \$16.3 billion, a 29% decline.

Since the fundamentals of the oil market haven't changed — current prices still are artificially high, and OPEC still has excess capacity. A move back to posted prices, with the Saudis as the swing producer, would put the market back where it was at the start of the year. There only be one change: Prices would be about \$18, rather than \$25 per barrel.

The strategy of posting an OPEC oil price of \$18 per barrel would cost the Saudis dearly. It would mean that their oil revenues would drop to \$16.3 billion in 1987, from \$34 billion in 1985, a 52% decline. (To put these oil revenues into context, recall that they were about \$113, \$76, \$48, and \$44 billion in 1981, 1982, 1983, and 1984, respectively. Add to this the fact that income from foreign Saudi investments has been falling (a 20% decline from 1984 through 1985) because interest rates have been falling and the Saudis have been forced to repatriate some capital to finance budget deficits, and we have a mega fiscal crisis.

Given that the Kingdom has already cut its budget rather close to the bone, it would be forced to place even more weight on devaluing the riyal. When Bretton Woods collapsed in 1971 the riyal was pegged at SR4.5 per dollar. In 1980, the riyal peaked in value at SR3.327 per dollar.

Since then, it has been devalued on a gradual basis, so as to squeeze more riyals out of oil sales, which are denominated in dollars. For example, the riyal was devalued by 1.1%, to SR3.65 per dollar, in June 1985 and by 2.7%, to SR3.75 per dollar, in June 1986.

Given the decline in oil revenues that would accompany the Saudi support of an \$18 per barrel oil price, devaluations, to be meaningful, would have to be in the 15%-25% range. Although more devaluations of the riyal are in the cards, devaluations of this magnitude probably would be outside the realm possibilities for the cautious King.

Even though it is fraught with the risk of unleashing more of the Iranian Majlis' venom, the Kingdom must manage its

vast oil reserves, so as to maximize their present value. This can be done only by stepping up output. Recall that in 1958, Crown Prince Feisal bin Abdul-Aziz was stunned, after he had wrested control from his spend-thrift brother, King Saud, when he visited the Kingdom's national treasury to find only 317 riyals. At this point, the story goes, Prince Feisal and other members of the royal family made a vow: Never again would the Kingdom's vaults be empty.

To assure that this vow is kept, King Fahd will have to continue to devalue the riyal modestly (or more than modestly, if he supports an \$18 per barrel posted price), and he will have to produce more oil.

STRATEGY: Add to short position in the riyal, and retain short position in crude oil. Regardless of how the king resolves his dilemma, this combination will prove to be a big winner.

— Steve H. Hanke

Chart 1

CRUDE OIL PRICE RESPONSES TO INCREASED CRUDE PRODUCTION
(Reproduced from *Commodity and Currency Comments*, November 17, 1985)

World Crude Production (million barrels/day)	Prices (\$/barrel)		
	Demand Elasticity (e = 0.1)	Demand Elasticity (e = 0.2)	Demand Elasticity (e = 0.3)
55*	\$28.60*	\$28.60*	\$28.60*
56	23.88	26.14	26.93
57	20.01	23.92	25.39
58	16.82	21.93	23.96
59	14.17	20.13	22.63
60	11.98	18.51	21.40
61	10.16	17.04	20.25
62	8.63	15.71	19.18
63	7.36	14.50	18.19
64	6.28	13.41	17.26
65	5.38	12.41	16.39

Notes: (1) The * denotes either the current assumed level of world crude oil production or the current assumed crude oil price.

(2) The demand model employed is:

$$Q = aP^{-e}$$

where Q = production of crude oil in millions of barrels per day,
P = price of crude oil in U.S. dollars per barrel,

$$e = \text{demand elasticity} = \frac{dQ}{dP} \times \frac{P}{Q}, \text{ and}$$

$$a = \text{a constant} = \frac{55}{28.60^{-e}}$$

(3) In the table, we increase production and solve for price with alternative demand elasticity assumptions. This is accomplished by rearranging the demand model, so that:

$$P = \left(\frac{Q}{a}\right)^{-\frac{1}{e}}$$

(4) For information on demand elasticities, see: Paul W. MacAvoy, *Crude Oil Prices: As Determined by OPEC and Market Fundamentals*, Cambridge, MA: Ballinger Publishing Company, 1982.

Chart 2

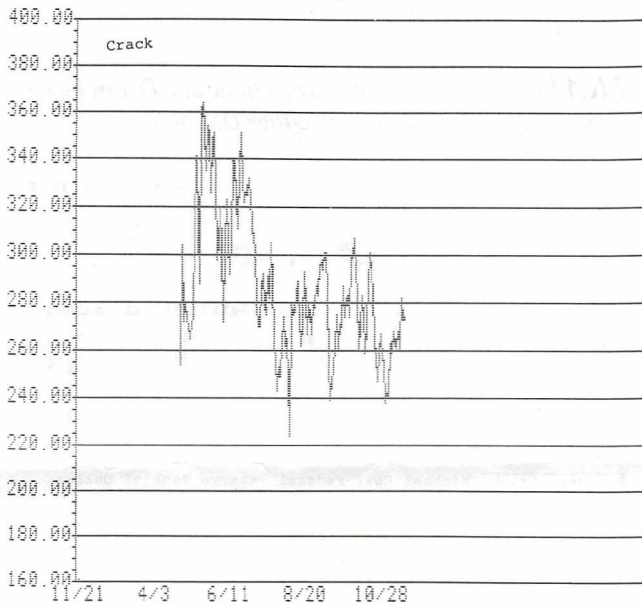
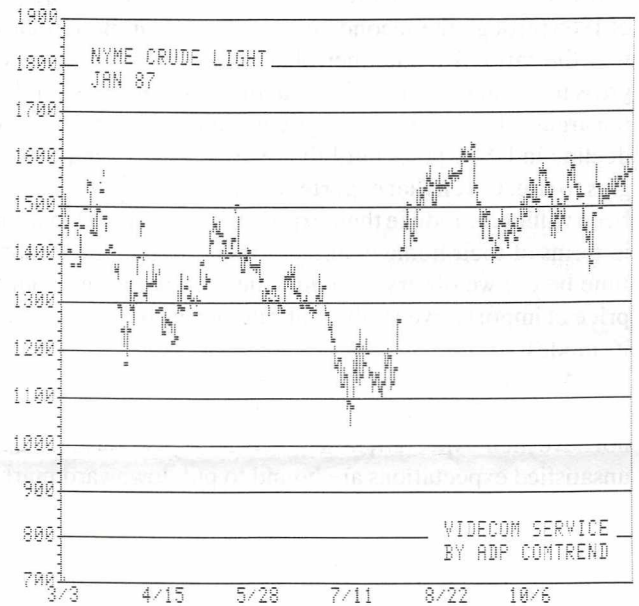


Chart 3



The unrelenting trade gap

On Oct. 31, 1986, we learned that the US trade deficit for September had "narrowed" to "only" \$12.6 billion. This brought a euphoric response from Washington, D.C. Commerce Secretary Malcolm Baldrige said, "I think we have turned the corner on the trade deficit." Obviously, the markets agreed with Mr. Baldrige. In consequence, we witnessed a mini dollar-rally.

For some time now, most Wall Street economists have predicted that the dramatic fall in the nominal value of the dollar, when calculated for traditional indexes, will eventually cause the trade gap to close. They have argued that it will take time for the decline in the dollar and the consequent increase in import prices and decrease in export prices to take hold. But they have assured us that when this occurs (and now they apparently believe that based on one month's data, it has), the so-called J-Curve phenomenon will be observed; the trade gap will narrow, and consequently the US economy will be given a much-needed boost.

We have not subscribed to this line of reasoning (see: *FC&CC*, Oct. 22, 1986). Rather, we have argued that the real value of the dollar, when weighted on the basis of US trade flows, has not fallen by nearly as much as the popular, nominal dollar indexes, which are weighted on the basis of financial flows. In consequence, changes in the real value of the dollar have not been great enough to cause the dramatic closing of the trade gap that most anticipate. Indeed, until the US either enters a recession that would reduce the demand for imports or the real value of the dollar actually falls much more than has been observed since early 1985, we cannot expect the deficit to close.

Our position is supported by the most recent data on real

exchange rates, which have been supplied to us by Dr. W. Michael Cox of the Federal Reserve Bank of Dallas (see: Chart 4). (For a more complete discussion of Dr. Cox's methodology, see: *FC&CC*, Oct. 22, 1986.) Chart 4 shows that through October 1986, the real value of the dollar has fallen only by 12.2% against a trade-weighted average of the US's top 131 trading partners' currencies. This means that in the aggregate, the US has become somewhat more competitive. Chart 4 also shows us that Europe, where the real value of the dollar has fallen by 29%, represents the only major grouping of countries in which the US has become significantly more competitive. However, Europe accounts for only about 20% of the US's trade flows.

If we turn from Europe to Latin America, the real value of the dollar has increased by almost 17%. Thus, US goods have actually become less competitive in relation to those produced in Latin America. The same can be said about the newly industrializing countries of the Pacific (PACNIC), where the real value of the dollar has appreciated by 2.2%. This explains, in part, why imports from Hong Kong, Korea, and Taiwan are pouring into the US. For example, the Korean Hyundai has captured 3% of the US auto market this year, starting from ground zero just two years ago!

Our analysis of the unrelenting trade gap has been further substantiated by Dr. Dallas "Sandy" Batten of the Federal Reserve Bank of St. Louis. Writing in the Bank's October 1986 issue of *International Economic Conditions*, Dr. Batten argues that the "depreciation" of the dollar will encourage the sale of US goods, both at home and abroad, only if the prices of goods reflect changes in real exchange rates.

Even though the real value of the dollar has fallen mod-

estly (Dr. Cox's X-131), it has not been accompanied by a rise in the relative price of imports. In fact, from the first quarter of 1985 through the second quarter of 1986, Dr. Batten shows that the ratio of US nonpetroleum import prices to the US gross national product deflator actually fell by 0.8%. Dr. Batten argues that, all other things constant, we cannot expect a decline in US imports until the relative price of imports begins to rise. Given that exporters to the US are able, and have been willing, to reduce their export prices and profit margins, in terms of their home country currencies, it could be some time before we observe a significant increase in the relative price of imports, even if the real value of the dollar continues its modest decline.

An unrelenting trade gap means that the politicians in Washington, D.C., as well as Wall Street's economists, will not have their expectations satisfied in the near future. These unsatisfied expectations are bound to put downward market

pressure on the dollar. They also promise to make those in Washington, D.C. more reluctant to put a safety net under the dollar.

STRATEGY: Remain long Swiss franc and Deutschmark. Replace long yen positions with either DM or SF.

— Steve H. Hanke

Chart 4

Real Dollar Indexes
(Based on 1973=100)

Date	X-131	PACNIC	Latin America	Europe
September 1980	84.2	96.3	94.3	75.7
March 1985	122.1	113.7	122.5	147.1
June 1986	105.7	115.7	141.1	104.0
October 1986	107.0	116.2	143.0	104.5
% Change to peak	+45.0%	+18.1%	+29.9%	94.3%
% Change from peak	-12.3%	+ 2.2%	+16.7%	-29.0%

Source: Dr. W. Michael Cox, Federal Reserve Bank of Dallas

Chart 5

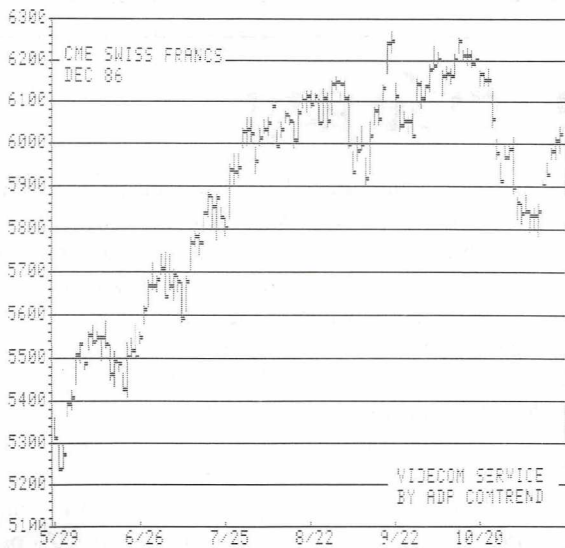


Chart 6

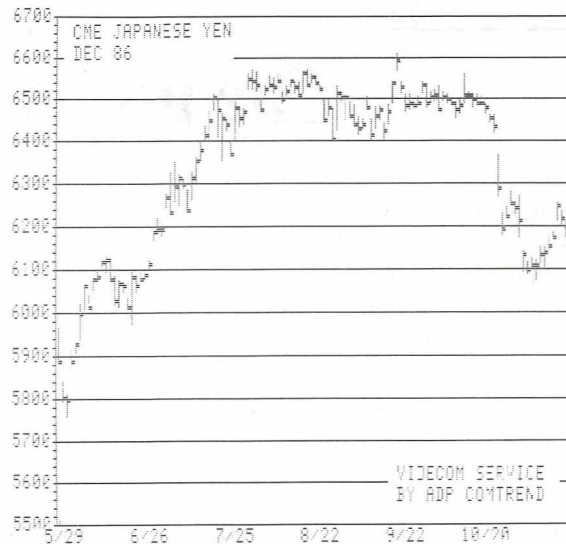


Chart 7

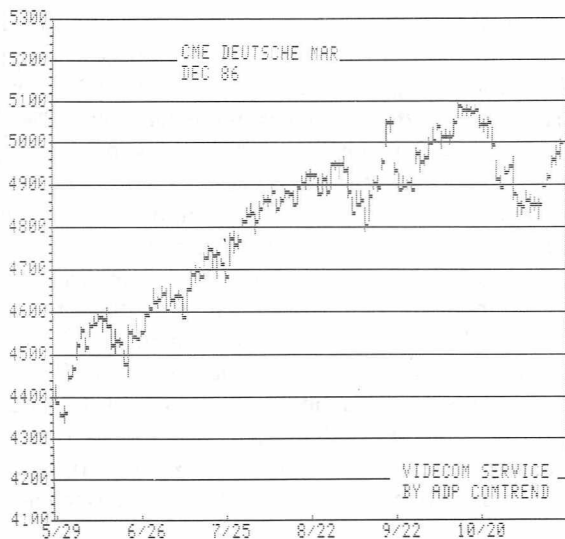
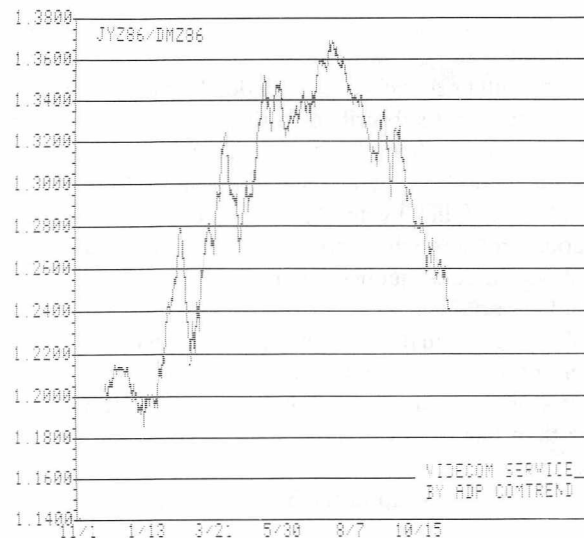


Chart 8



Stock Indexes

The rebound from the September lows was not able to fire up the Wall Street crowd. Except for the feverish takeover activity and its direct impact on stock prices, very few companies scored yearly highs, a sign that breadth continues to lag badly. Clearly, soft economic figures do not support a further revaluation of earnings. The same can be said about gently rising short-term interest rates.

Takeover activity and the extraordinary high prices being paid for relatively mundane businesses present a formidable puzzle. The puzzle is further compounded by the fact that on balance, takeover artists are successful in profitably dismembering their acquisitions and selling off the parts, be it subsidiaries or assets. The existence of this form of "arbitrage" is a strong rebuttal to the "efficient market" hypothesis. But why are so many analysts and market participants wrong?

Leverage, of course, or the increased willingness to leverage may be a very important reason why *shareholders' returns* are being improved beyond what generally prudent financial analysts or management are willing to undertake. As mores and attitudes about debt change, more and more stocks that *earn returns on assets higher than current money rates* are being evaluated on the basis of very thin equity and consequently explosively high returns on equity. Thus, the infatuation with pretax cash-flows, a yardstick that serves to measure capacity to repay debt.

The market's reticence or inertia to mark up prices in line with the higher, leveraged returns on equity is a function of cultural inhibitions — inhibitions that are fast disappearing under the influence of the Perelmans, Icahns, Pickens and so on. It may be interesting to speculate why these players are so uninhibited. Could it be that unlike management, these predators have little to lose (after all, junk bond financing and other fancy bank credit do not require *personal guarantees*)? Whatever the reason, leveraging over a very thin layer of equity will not cease until a) prices have fully reflected these potential gains, or b) interest rates rise and make leveraging unprofitable, or c) earnings begin to collapse under the weight of a recession.

In some circumstances, particularly the very large capitalization companies, entrenched management has succeeded over the past 20 years in building size at the expense of profitability. This has come about because shareholdings are extremely large and dispersed, and are unable to effectively communicate to management the idea of bottom line performance. These industrial giants are too large, too bureaucratic, and as a result, analytically too impenetrable for even management to know how assets can be redeployed and shareholders' returns on equity maximized (without necessarily leveraging the shop). Entrenched management is interested only in preserving jobs, which can be done only in the context of a large and growing industrial enterprise; asset disposals, restructurings, spinoffs are inimical to a management

bureaucracy. Only takeover threats seem to be able to shake off this lethargy.

The view of entrenched management as a bureaucracy — slow to react, inefficient and incapable of analyzing, let alone communicating with, the marketplace, the true value of myriads of assets hidden under the heading of "in billions of dollars," and inflated by 20 years of persistent and high inflation — helps explain the mouth-watering premiums above market prices being paid for rather mundane companies.

If our thesis is correct, the efficient market hypothesis is correct insofar as it deals with the "known" factors. What is unknown requires a leap of faith that only takeover artists, with unlimited financing and no personal risk, can fathom: The market value of a few well-known, simple-to-analyze subsidiaries; the assumption that certain assets carried at book value since the early part of the century (or even as recently as the fifties) may be worth a multiple of this value; the knowledge that certain subsidiaries may be worth substantially more than a "market multiple" to a particular company that is trying to carve out a specific niche; and, of course, the ever-present possibility of leveraging or taking public segments of the acquired giant. Even here, the market is likely to learn the "game" and begin making simplistic but heroic assumptions. The multitude of recent deals tells us that the cup has, as yet, not runneth over!

How else are we to understand how Safeway (see Chart 9) is undergoing a leveraged buy-out at \$69 per share when S&P estimates earnings for 1986 at \$3.15 per share, about the same as earned in 1982 and slightly below what was earned in 1983? Would a sane analyst recommend Safeway at 22 times earnings? or Goodyear (see Chart 10) at 15 times estimated 1986 earnings, that fail to better those achieved in 1978? Or Lear Siegler (see Chart 11) at \$93, 28 times trailing 12 months' earnings, earnings that are 26% below those achieved in 1979?

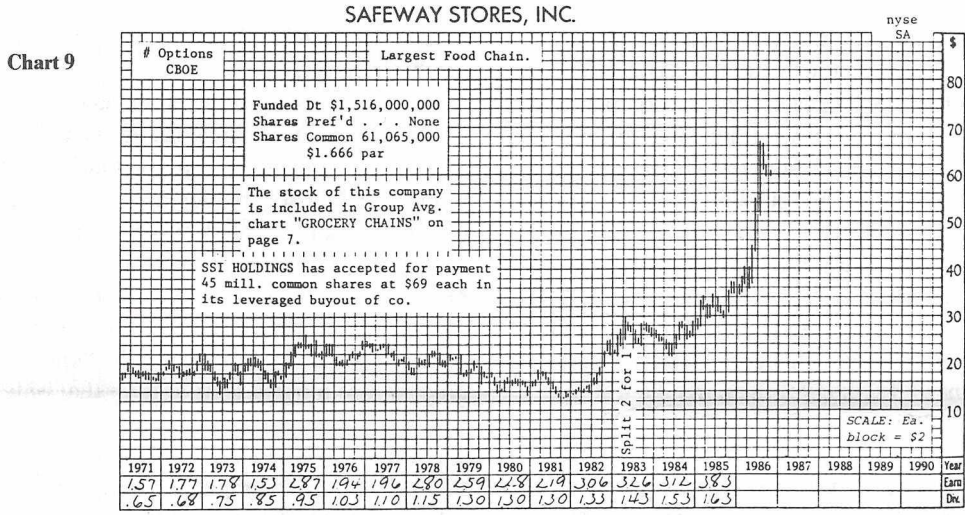
As the large capitalization stocks moved closer to "market" values, their premiums relative to small cap stocks widened. While the former are primarily asset driven, as demonstrated, the latter must stand on earnings growth, not a particularly exciting prospect in a slow growing economy.

Although the revaluation process has clearly not ended, as witnessed by the recent frantic pace of takeovers, the value added numbers are probably not as dramatic, a direct result of the market's slow but certain learning experience. As a result, the ratio of high caps to low caps has stopped widening and, in fact, low caps have begun to hold their own. As the universe of large, undervalued companies diminishes, the tilt towards the low caps will favor our long Value Line/short S&P spread (see Chart 8).

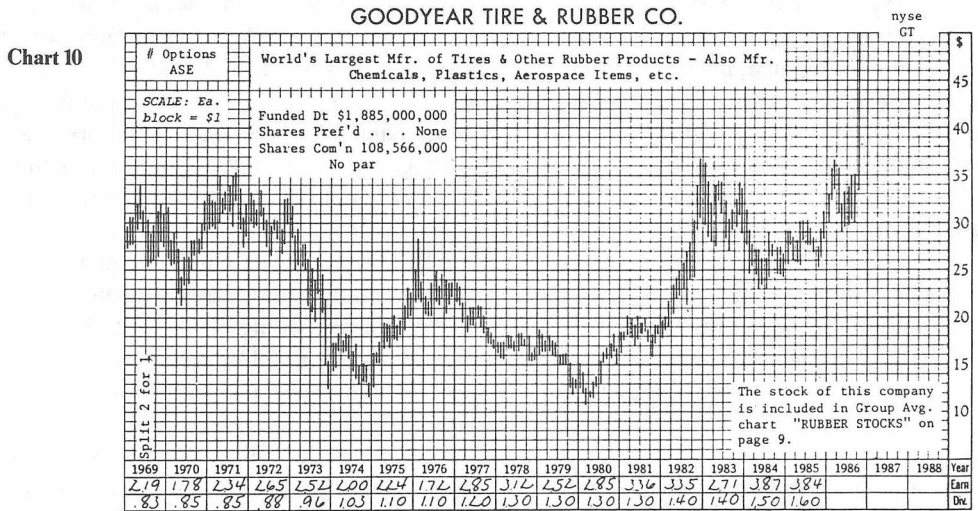
STRATEGY: Retain long Value Line/short S&P spread; roll forward to March '87. On Nov. 6 we advised liquidating long stock index futures recommended in our last issue, dated

Oct. 22 and mailed Oct. 24. Assuming entry on Tuesday, Oct. 28, our estimated profit was 500 points, or \$2,500 per contract.

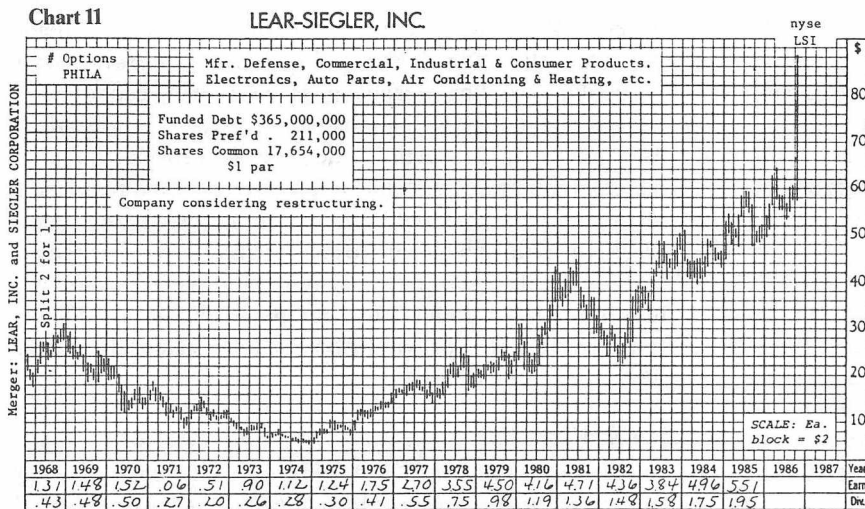
We now advise selling December '87 S&P at market, risking 24850, good any time.



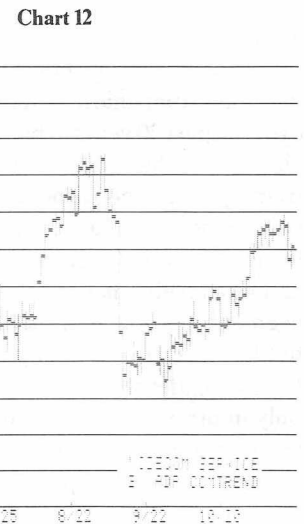
*The Stock Picture, M.C. Horsey & Co. Inc.



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*The Stock Picture, M.C. Horsey & Co. Inc.



Precious Metals

Gold

Under the influence of a dramatic fall in platinum prices, gold has extended its downward correction and is now approximately 10% off its September recovery highs. At the same time, we are approaching the critical 50% retracement of the entire bull move, which began in June at \$340-\$350/oz.

There is little in the fundamental picture to suggest an early end to the bull market. US external indebtedness continues to mount, monetary conditions in the US and abroad remain extremely easy, inflation as measured by the CPI is on the rise, international commodity prices have stabilized, the US dollar is under continuous pressure (and likely to remain

so for yet a while), and credit quality deteriorates steadily. These factors are causing a shift of portfolio preference towards gold if ever so slight — factors that are likely to boost prices significantly. (Buoyant gold coin sales in the U.S. and abroad are merely reflecting this ongoing shift.)

STRATEGY: Long positions were added on the recent Correction as per our advice last month. Short-term traders only should place stops at 376, basis December '86, close only. We are emphatic that long-term holders should not disturb their long positions, regardless of any short-term weakness.

Chart 13

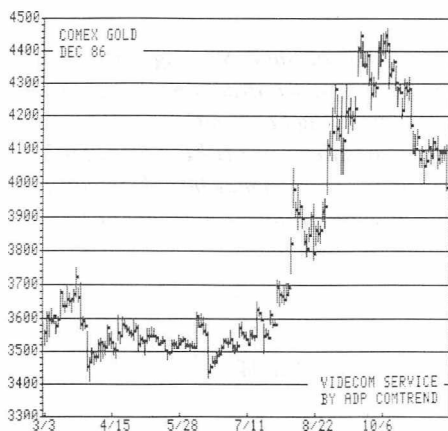


Chart 14



Silver

Silver is completing a magnificent long-term bottom (see Chart 16). We are turning bullish for the first time in seven years.

STRATEGY: Buy in a breakout above 6.30, basis March 87, close only.

Chart 15

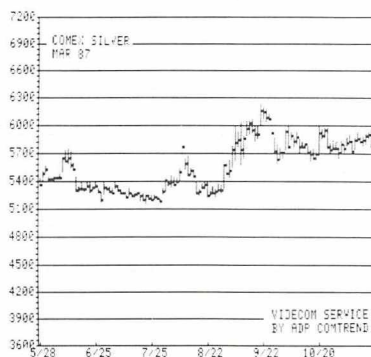
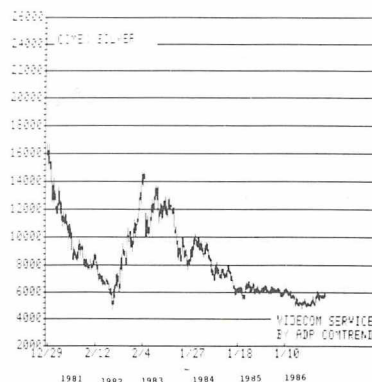


Chart 16



Currencies

British pound

The announcement that Britain's foreign currency reserves fell by an underlying \$668 million in October came as little surprise to our readers, who have been short Sterling since the summer. In just over two months, Britain had lost one quarter of the jumbo \$4 billion Euroloan raised in September for the purpose of boosting reserves.

It appears that Mr. Lawson prevailed over Mrs. Thatcher in regards to the defence of a Sterling forex value. The Iron Lady would have preferred to let the exchange rate take the selling rather than committing reserves and/or raising interest rates. Mr. Lawson argued that a further fall in Sterling may jeopardize the government's inflation forecasts.

Britain's credit-led boom has entered its fifth full year, and it is showing serious signs of strain. As consumer expenditures continue to explode (4½% in real terms, year over year), imports surge. Up to 45% of any increase in consumption is met by imports, with this proportion rising as spending increases (Britain has literally run out of domestic capacity in many lines). As a result, the non-oil trade deficit has widened to 1.2 billion Sterling per month from 800 million Sterling last year.

Fuelling the consumer (and housing) boom is the extraor-

dinary increase in money and credit experienced in the past 18 months. Adding fire to the fuel (in an attempt to boost its own electoral standing), the Thatcher government announced a big £10.2 billion increase in spending to previous spending targets over the next two years. This Keynesian prop coming atop of an overheating economy has unsettled the money and bond markets. The long end of the market (more than 15 years) is now trading at an 11% yield despite the low rate of inflation (RPI of 3½%, year over year), a dramatic sign of disbelief. Three months' Sterling deposit rates trade at 11¼%, anticipating a foreign exchange crisis and some tightening moves. Technical trends (see Charts 20 and 21) point to substantially higher interest rates in the near future.

The Thatcher experiment is about to end in disaster. By next fall, with Sterling much lower, and inflation and interest rates much higher, the Tories will face an electoral revolt.

STRATEGY: Remain short Sterling versus long positions in DM and SF. Recent small corrections (see Charts 17, 18, 19) are merely pauses in a long bear market.

Initiate short positions in LIFFE short Sterling deposits and LIFFE long Gilts. Lawson may be able to contain the slide in Sterling (for a while, at least) but only at the expense of much higher interest rates.

Chart 17

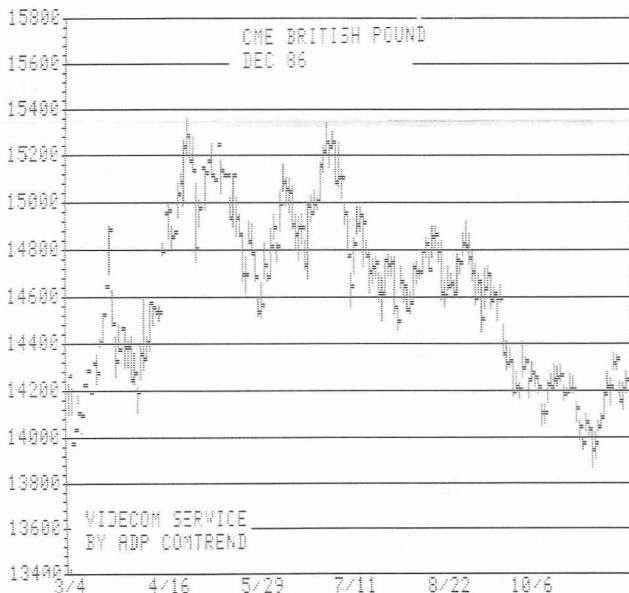


Chart 18

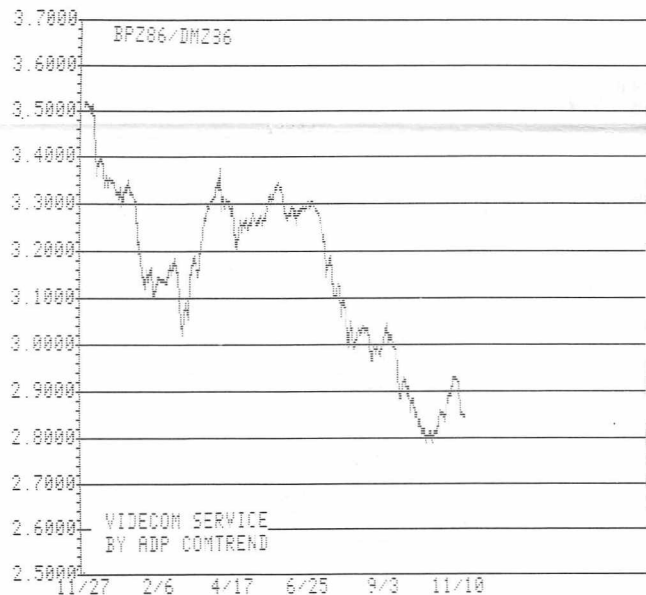


Chart 19

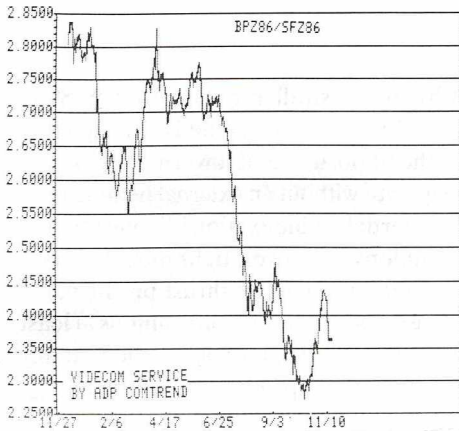


Chart 20

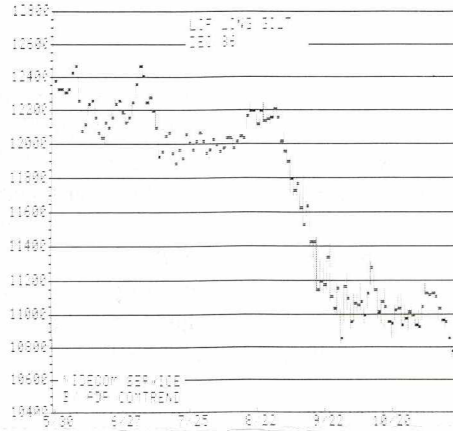
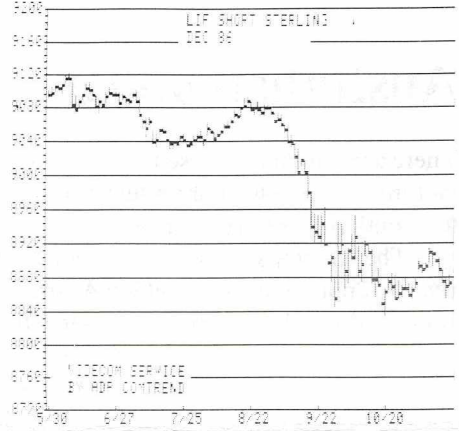


Chart 21



Canadian dollar

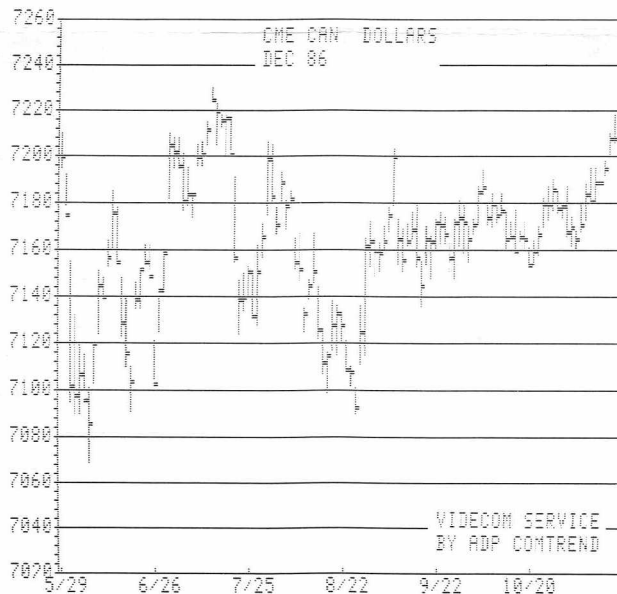
The Canadian government has found a new tool to re-compose badly depleted reserves. It issues US pay 3-month Treasury bills in the New York market at a substantial savings in interest costs compared with LIBOR-based bank borrowings. This balance-of-payment-related borrowing operation also serves to fund fiscal borrowing repayments.

During October, Canada's international reserves rose by \$602 million more than accounted for by the issuance of \$632 million US pay Treasury bills. The program seems successful enough to provide a significant foreign exchange cushion in the months ahead. Nonetheless, we believe that *ex ante* demand for US dollars over the next 12 months of about \$25 billion (\$12 billion current account deficit, \$5 billion net di-

rect foreign investment, and \$8 billion capital flight) will overwhelm this important source of US dollars and will necessitate a continuing gap in interest rates vis à vis the US and a substantial depreciation of the currency (a minimum of 5%).

STRATEGY: *The bear case is getting stronger. Canada's net foreign indebtedness is rising at a time when tax rates favor Southward-bound capital flows, terms of trade remain depressed, and inflation is running higher than the US. Timing is essential, as forward discounts are quite substantial. We favor buying at-the-money puts and simultaneously selling slightly out-of-the-money calls. Otherwise, sell June '87 Canadian dollar and place stops at 72.60, basis spot.*

Chart 22



The Exotics

Australian dollar

There are a number of essential ingredients in the Australian picture, not all which are relevant to the near- to medium-term outlook for the currency.

The country's external debt has doubled in the past two years to approximately 90 billion Australian dollars, due to a combination of large current account deficits equal to around 6% of GDP and the depreciation of the Australian dollar, which translated foreign currency debt into much higher local equivalents. Still, total foreign debt equals only 36.5% of GDP — surely not a catastrophic level by international standards. Net public international debt equals only US\$11 billion.

Australia's main problem for the past few years has been the relentless drop in its terms of trade — 14.5% since 1980. This is because Australia is mainly a commodity exporter, (coal, wool, sugar, and other cereals) and a manufactured product importer. The correct response in the face of this national impoverishment should have been a substantial real decline of wages. Instead, wages maintained throughout this period their real purchasing power and rose vis à vis US wages by well over 30%. The drop in the standard living had to appear somewhere. It was finally reflected in the massive depre-

ciation experienced by the Australian dollar; from 1980 to date it dropped by 44%. In recent weeks the Hawke government came to realize the importance of lowering real wages to achieve sustainable growth without an external hemorrhage.

The move towards partial de-indexation is being resisted by the powerful labor unions. However, tight monetary policy coupled with a contractionary fiscal thrust produced by the Keating budget of last August should force unions at least in the near term to comply with the new wage policy. At any rate, labor's reluctance is likely to produce rising unemployment in the coming months.

Australia is now most probably experiencing a recession, which will help the balance of trade, despite the continuous deterioration in the terms of trade. Nevertheless, the current account deficit will not improve significantly, as services represent as much as 75% of the overall deficit.

STRATEGY: Look for the Australian dollar to continue to firm in the near term as trade figures and competitiveness improve, and very high interest rates continue to act as a magnet for capital inflows. Maintain profitable long positions against US dollar and DM. Place stops at .6250 against the US unit, which should also trigger liquidation against the DM.

Chart 23

YEAR	AUSTRALIAN DOLLAR PER U.S. DOLLAR (PERIOD AVG.)		U.S. -1.00		U.S. -1.00	
	1967	1973	1967	1973	1967	1973
1967	1.1125	1.0000	1.2925	1.0000	1.2253	
1968	1.1125	1.0150	1.3119	0.9436	1.1561	
1969	1.1110	1.0419	1.3466	0.9653	1.1828	
1970	1.1137	1.0587	1.3683	0.9844	1.2062	
1971	1.1361	1.0214	1.3202	0.9830	1.2045	
1972	1.1925	0.9515	1.2297	0.9511	1.1654	
1973	1.4195	0.7737	1.0000	0.8161	1.0000	
1974	1.4378	0.7563	0.9517	0.7839	0.9605	
1975	1.3102	0.7671	0.9915	0.8152	0.9988	
1976	1.2252	0.7645	0.9880	0.7700	0.9435	
1977	1.1090	0.8016	1.0360	0.8275	1.0140	
1978	1.1447	0.7735	0.9997	0.8449	1.0353	
1979	1.1179	0.8082	1.0446	0.9137	1.1196	
1980	1.1395	0.8172	1.0562	0.9512	1.1655	
1981	1.1495	0.8154	1.0539	0.8882	1.0884	
1982	1.0174	0.8792	1.1564	0.9100	1.1150	
1983	0.9024	0.9296	1.2015	0.9135	1.1193	
1984	0.8796	0.9563	1.2360	0.8846	1.0839	
1985	0.7008	1.1638	1.5042	1.0630	1.3025	
1986 (1Q)	0.7014	1.1192	1.4465	1.0819	1.3256	
1986 (2Q)	0.7130	1.0719	1.3854	1.0714	1.3128	

Above 1.00 = undervalued
Below 1.00 = overvalued

Chart 24

Year	Foreign Assets (Min US\$)	CURRENT ACCOUNT		CUMULATIVE 12 QTR.	
		As % of GNP	As % of GNP	Current Account	(Min US\$)
1970	1,817	-2.35	-2.35	-3135	
1971	3,330	-2.11	-2.11	-2621	
1972	6,079	+0.09	+0.09	1250	
1973	5,776	-0.06	-0.06	+11	
1974	4,137	-3.44	-3.44	-1952	
1975	3,653	-1.13	-1.13	-3408	
1976	2,571	-1.99	-1.99	-5780	
1977	2,952	-3.00	-3.00	-6040	
1978	3,411	-4.06	-4.06	-9563	
1979	4,016	-2.16	-2.16	-10267	
1980	6,573	-2.90	-2.90	-11331	
1981	4,474	-5.13	-5.13	-15153	
1982	8,912	-5.36	-5.36	-20797	
1983	11,487	-3.78	-3.78	-22500	
1984	8,716	-4.82	-4.82	-22445	
1985	6,890	-6.17	-6.17	-23483	
1986 (Apr.)	6,782	-	-	-	

Chart 25

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

Reserves * + Previous 12-months current Account *** - 988
(Reserves + 12-months C/A) / M1 ** = Nil
(Reserves + 12-months C/A) / Broad Money ** = Nil
*As at Jul. 1986 ** May 1986 *** 1986 Estimated

Figures in millions of U.S. Dollars

	M1 (Converted to U.S. Dollars)	Broad Money (Converted to U.S. Dollars)
1976	11,603	39,762
1986 (May)	16,138	56,650
% Increase (decrease)	39.0%	42.4%

Corresponding % increase in the United States

(a) 1985 Imports as percentage of GNP 16.49%
(b) 1976 - 1985 Imports as percentage of GNP 13.72%
1985 / 1976 - 1985 average = (a)/(b) = 120.19%

Source: IFS

Chart 26

SPOT	1 - Month	3 - Month	6 - Month	12 - Month
.6455-	.6402-	.6302-	.6168	.5925-
.6460	.6410	.6311	.6178	.5940

Belgian franc

Belgium's performance continues to be relatively mediocre. It has the lowest rate of growth in the OECD except for Ireland and New Zealand. There has been a small improvement in the central government net borrowing requirement, which fell to 8.5% of GNP this year from 10.2% last year, largely a product of reduced interest changes on the public debt. The public sector's total debt has now risen to 5.4 trillion francs, up from 4.9 trillion a year earlier, representing 110% of GNP. Interest charges on the public debt easily exceed the fiscal deficit and threatens to become self perpetuating.

The current account has swung into an expected 68.7 billion franc surplus from a 500 million franc deficit last year, the first current account surplus since 1976. Nevertheless, Belgium is funding large capital outflows, such as direct investments abroad, via short-term liabilities. Over the past seven years, Belgium's foreign assets have dropped almost US\$17 billion.

STRATEGY: Large reserves and prospects for a large current account surplus are positive influences on the franc, at least for the near term. Over the long term, the growing indebtedness seriously threatens the stability of the country. Remain long against both US\$ and DM.

Chart 27

YEAR	BELGIAN FRANCS PER U.S. DOLLAR (PERIOD AVG.)	U.S.		BASKET	
		1970 =1.00	1977 =1.00	1970 =1.00	1977 =1.00
1967	49.62	0.9500	1.6039	1.0093	1.3326
1968	50.14	0.9738	1.6441	0.9731	1.2847
1969	49.66	0.9806	1.6556	0.9753	1.2877
1970	49.67	1.0000	1.6884	1.0000	1.3205
1971	44.75	0.8989	1.5177	0.9443	1.2467
1972	44.06	0.8683	1.4660	0.9828	1.2976
1973	41.32	0.8086	1.3653	0.9925	1.3103
1974	36.12	0.6953	1.1739	0.8512	1.1238
1975	39.52	0.7370	1.2443	0.9561	1.2622
1976	35.98	0.6506	1.0985	0.7965	1.0515
1977	32.94	0.5923	1.0000	0.7574	1.0000
1978	28.88	0.5345	0.9025	0.7448	0.9835
1979	28.04	0.5528	0.9334	0.8162	1.0776
1980	31.52	0.6615	1.1169	1.0062	1.3285
1981	38.46	0.8281	1.3982	1.0865	1.4342
1982	46.92	0.9855	1.6639	1.1620	1.5341
1983	55.46	1.1168	1.8855	1.2129	1.6013
1984	63.08	1.2457	2.1033	1.2223	1.6137
1985	50.36	0.9816	1.6573	0.9453	1.2480
1986(1Q)	47.48	0.9304	1.5709	1.0261	1.3547
1986(2Q)	44.93	0.8774	1.4814	1.0104	1.3340

U.S. 8% ITALY 6%
U.K. 13% FRANCE 23%
Germany 27% NETHERLANDS 23%

Above 1.00 = undervalued
Under 1.00 = overvalued

Chart 29

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

Reserves * + Previous 12-months curren Account *** = 19286
(Reserves + 12-months C/A) / M1 ** = 19286/20537 = 93.9%
(Reserves + 12-months C/A) / Broad Money ** = 19286/46539 = 41.4%

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

Figures in millions of U.S. Dollars

	M1 (Converted to U.S. Dollars)	Broad Money (Converted to U.S. Dollars)
1976	19013	34313
1986 (March)	20537	46539
% Increase (decrease)	8.01%	35.65%
Corresponding % increase in the United States	98.2%	115.5%

(a) 1984 Imports as percentage of GNP 60.39
(b) 1975 - 1984 Imports as percentage of GNP 49.72
1984 /1975 - 1984 average) = (a)/(b) = 121.46

Source: IFS

Chart 28

Year	Foreign Assets (Min US\$)	CURRENT ACCOUNT		CUMULATIVE 12 QTR.
		As % of GNP	%	Current Account (Min US\$)
1970	2110	2.75		987
1971	2930	2.22		1605
1972	3340	3.60		2659
1973	3680	2.99		3319
1974	3530	1.43		3447
1975	3960	0.28		2332
1976	3810	0.63		1390
1977	3420	-0.69		62
1978	2240	-0.84		-936
1979	-1610	-2.79		-4448
1980	-1900	-4.14		-8839
1981	-6120	-4.28		-12196
1982	-7490	-3.05		-11735
1983	-9000	-0.53		- 7221
1984	-9505	0.00		- 3047
1985	-14293	-		- 551

Chart 30

SPOT	1 - Month	3 - Month	6 - Month	12 - Month
41.62-41.72	41.65-41.77	41.74-41.88	41.86-42.01	42.02-42.27

Forex Rates & Update

<i>Currency</i>	<i>Spot</i>	<i>3-Month</i>	<i>12-Month</i>	<i>Comments vis à vis US\$</i>	<i>Comments vis à vis DM (Spot DM 2.0030)</i>
Danish krone	7.5850-7.5900	7.6530-7.6630	7.8550-7.8800	Neutral	Remain short
Dutch guilder	2.2630-2.2640	2.2597-2.2610	2.2470-2.2490	Remain long	Remain long
Greek drachma	137.85-138.05	143.85-147.05	158.85-169.05	Neutral	Remain short
Italian lira	1387-1389	1388-1391	1392-1395	Remain long	Neutral
Kuwaiti dinar	.29345-.29365	.29410-.29470	.29550-.29930	Neutral	Remain short
Malaysian ringgit	2.6120-2.6140	2.6220-2.6340	2.6620-2.7640	Neutral	Neutral
New Zealand dollar	.5160-.5170	.5018-.5038	.4670-.4720	Remain long	Remain long
Norwegian krone	7.4750-7.4800	7.6395-7.6475	8.0740-8.0890	Remain long	Neutral
Portugese escudo	148.15-148.40	151.55-152.80	156.15-165.40	Neutral	Neutral
Saudi Arabian riyal	3.7500-3.7510	3.7635-3.7675	3.8050-3.8160	Remain short	Remain short
Singapore dollar	2.1920-2.1930	2.1775-2.1792	2.1445-2.1555	Remain short; stop 2.1400, basis spot	Remain short; stop 4.2700, basis spot
Spanish peseta	134.90-135.10	136.90-137.40	141.40-142.90	Neutral	Neutral
Swedish krona	6.9150-6.9200	6.9600-6.9685	7.0665-7.0815	Remain long	Neutral
Venezuelan bolivar	25.60-25.70	26.00-27.25	26.75-28.25	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

Friday, Oct. 24: No changes or new recommendations. Market letter was mailed today. Next regular update October 28.

Tuesday, Oct. 28: No changes or new recommendations. Market letter was mailed on Friday.

Friday, Oct. 31: No changes or new recommendations.

Tuesday, Nov. 4: No changes or new recommendations. Next regular update Friday, Nov. 7.

Flash update, Thursday, Nov. 6, 12:15 p.m.: Liquidate *the outright* long positions in stock index futures, at the market, accepting handsome profits.

Friday, Nov. 7: One change this week. As of our flash update at noon yesterday, we have taken profits on all outright long positions in stock market futures.

Tuesday, Nov. 11: No changes or new recommendations.

Friday, Nov. 14: No changes or new recommendations.

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