

FRIEDBERG'S

COMMODITY & CURRENCY COMMENTS

Friedberg Commodity Management Inc.



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Printing (a lot of) money

It has often been said that one picture is worth more than one thousand words. We present two pictures, one alongside the other, so that the proper inferences can be made and to save a long and complex narrative.

The level of US interest rates has been cut in half since 1984 (Chart 1). Making the connection to a permissive monetary policy (Chart 2) is quite tempting. What is remarkable is the acceleration in the growth of money supply required to produce the persistent downtrend in rates: to an explosive annual rate of 17.6% from 5.8%.

This policy of lowering interest rates has not come without significant side effects. The US dollar has tumbled since early 1985, at about the time printing presses went to work overtime. Perhaps it was desirable, or, more accurately perhaps, it was the intention of the monetary authorities to accomplish this depreciation. In fact, we are quite certain that this was their intention. But what is instructive is that too much money equates with cheap money.

Interest rates, as portrayed by the ultrasensitive three-month LIBOR, seem to be breaking out of this downtrend, despite, or perhaps because of, huge monetary accommoda-

tion. Let us explain. The supply effect of rising money supply depresses interest rates; the demand effect, however, raises interest rates as users vie to borrow a unit of account that is likely to get cheaper over time and that can be repaid with less real purchasing power. In unmanaged markets, the supply effect is strongest at the short end of the market and rates trade below their "natural," or equilibrium, rate. At the long end of the market, however, rates rise because the demand effect is strongest. Typically, the result is a steep, positively sloped yield curve.

Let us be a bit more concrete. If the Fed wants to maintain the downtrend in interest rates, or merely keep rates from rising, it will have to step up the already dramatic pace of monetary stimulation. The abundant supply of cheap money affects prices and short-term interest rates turn negative. The

Chart 1

EURO-DOLLAR DEPOSIT RATES LONDON
AVERAGES FOR WEEK ENDING WEDNESDAY

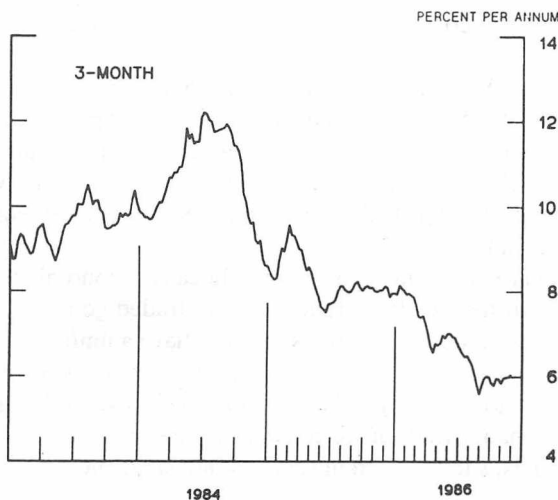
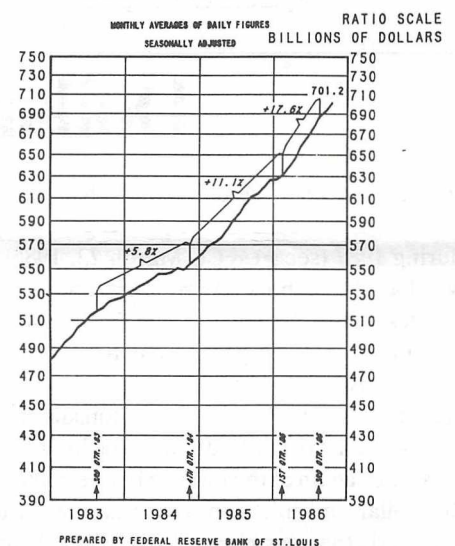


Chart 2

MONEY STOCK (M1)



In this issue

The dollar is down, inflation is up, and gold probably will soar. So, naturally, we remain long gold. We decide the stock markets are too tough to call, so we remain sidelined. And in oil... what else but short? Contributions by Albert D. Friedberg, Steve H. Hanke, and Daniel A. Gordon

dollar continues to fall, reinforcing the trend to higher inflation (see next article). Eventually, the dam bursts, the Fed recognizes (rather belatedly) its mistake, and interest rates jump.

It happened in Brazil, where short-term rates jumped overnight, to 150% from 30% to 40%. It is happening in the UK, where short-term interest rates hover around 11.25%, while measured consumer inflation does not exceed 3.5%; in Denmark, in France the story is the same.

Conclusion: Abundant money makes for cheap money, which makes for a depreciating currency, inflation and, ultimately, rising interest rates.

STRATEGY: A very interesting trading opportunity presents itself. The risk of shorting March '87 and June '87 Eurodollars is almost negligible. They already trade 10 to 20 basis points more expensive than spot (that is, lower implied rates); the stop is well defined, as we are willing to risk only a close above 94.25 (in the eventuality that the Fed doubles its printing capacity). As our analysis indicated, T-bonds are even more likely to collapse under the weight of cheap money. The failed attempt to break out of a long-term triangle (Chart 3) may be the first sign that this market is top heavy. Sell (as already suggested in the Hotline of Dec. 5) March '87 T-bonds, risking 100.31, close only.

Chart 3

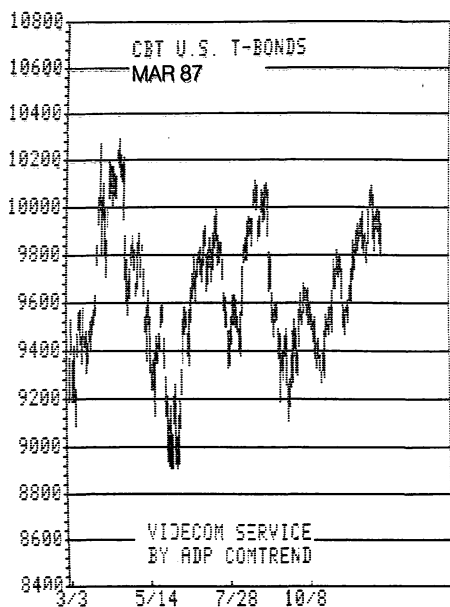
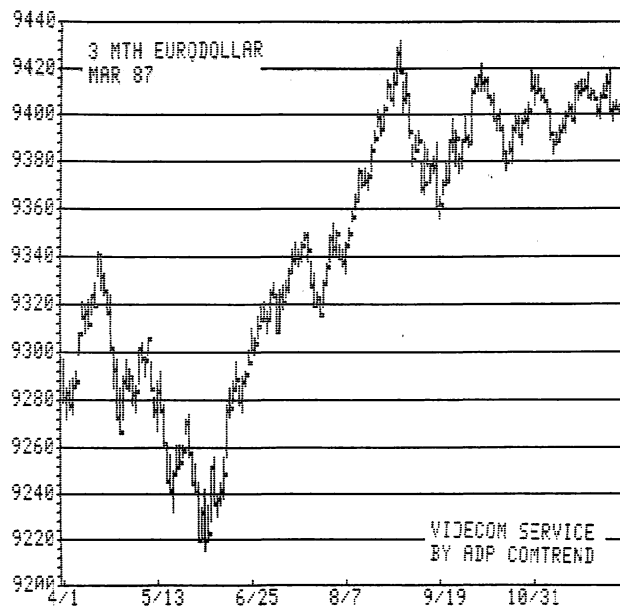


Chart 4



Dollar Down, Inflation Up

Earlier this year, we concluded that the decline in the exchange value of the dollar portended an up-tick in inflation during 1987 (see *FC&CC* March 23, 1986). This conclusion was based on an extensive literature, which shows that regardless of the channel through which a declining dollar transmits inflation, each permanent 10% drop in the value of the dollar is associated with an eventual (in about two years) increase of about 1% to 2% in the consumer price index.

Since 1987 is rapidly approaching, it is appropriate to look once again at the linkage between the exchange value of the dollar and inflation. Our reappraisal is facilitated by a new study that was kindly made available to us in advance by the Federal Reserve Bank of Atlanta.

Past studies of the dollar-inflation linkage attempt to model specific channels, such as import prices or wages, through which changes in the dollar's exchange value affect general price indexes. The authors (Messrs. Whitt, Koch, and Rosensweig) of the Atlanta Fed's study discard the partial, channel approach, which has been used by others. Instead,

they employ a dynamic mathematical model that is designed to capture the nature and extent of all price responses associated with changes in the external value of the dollar. Of particular importance is the fact that the dynamic model is well suited to uncover the length and patterns of all lagged price effects.

The Atlanta study uses monthly data for exchange values and price indexes. The data analyzed start in April 1973, after the floating exchange rate regime was fully in place, and end in June 1985. To summarize movements in the exchange value of the dollar, the Federal Reserve Board's Trade-Weighted Dollar Index is used.

Three price indexes are used because economic theory distinguishes between traded and nontraded goods. Theory suggests that exchange rates may not have a uniform link to all domestic prices. For example, it is usually assumed that the prices of traded goods are highly responsive to changes in the exchange value of the dollar, while the prices of nontraded products, such as certain services, housing, and real estate,

are not. The consumer price index for all items ("CPI, all items") is used, so that the study's results can be compared with others that have used this index. The consumer price index for services ("CPI, services") is a proxy for nontraded items, while the proxy for traded goods is the producer price index for finished goods ("PPI, finished goods").

The results obtained from applying the dynamic, distributed lag model to these data are robust and confirm the general findings of past studies: a decline in the exchange value of the dollar is followed by an increase in price indexes, while an increase in the dollar's exchange value is followed by a decrease in price indexes.

The findings of the new study, however, differ from those reported in past studies in several important ways. First, the new study shows that exchange rate movements were followed by changes in price indexes that were substantially larger than those measured by past studies (see Chart 5). For example, the new study finds that a permanent 10% drop in the value of the dollar was followed by an ultimate increase in the "CPI, all items" of 4.85% (see Chart 5); most past studies indicated that this measure of inflation increased by only 1% to 2% after a permanent 10% decline in the dollar's exchange value. Second, the new study found that the lags between exchange rate changes and price index changes continue for much longer than previously believed. For example, over half of the total cumulative change in prices comes more than a year following an exchange rate change, and sizable effects occur beyond two years. In consequence, the inflationary effects of a decline in the exchange value of the dollar continue to be felt long after exchange rates have stabilized.

It is worth mentioning that all the indexes used, even the "CPI services," show substantial price level responses following changes in exchange rates. Since most of the services in the "CPI, services" index are not traded internationally, it would seem that exchange rates should have little direct ef-

fect on prices of services. Contrary to what is expected from theory, however, the strong response of the "CPI, services" index may reflect indirect effects from exchange rate changes to wages, interest rates, or aggregate demand conditions.

The implications of these new findings about the dollar-inflation linkage are rather profound. First, if history is our guide, the inflationary effects of the dollar's falling exchange values will probably be more than double what we had originally anticipated. Second, most of the inflationary effects of past declines in the exchange value of the dollar have yet to be realized. Just consider the following: the dollar declined on the Fed's index by 10% from February 1985 to July 1985; it fell another 10% from July 1985 to December 1985; and it fell another 10% from December 1985 to July 1986. By now, it has fallen a grand total of 32%. Given the structure of lags found in the new study, this means that only about 33% of the inflationary effects (4.87% inflation on the "CPI, all items" index) from the decline in the dollar's exchange value has been felt. With 67% percent of the inflationary effects (9.68% inflation on the "CPI, all items index) from the declines in the dollar's exchange value still to be felt (and further declines in the exchange value of the dollar anticipated), it should be clear that 1987 will usher in inflation (4.78% on top of current rates on the "CPI, all items" index by the end of 1987) that past declines in the dollar's exchange value have already cranked into the economy. Given that long-term interest rates are equal to a real interest rate, plus a risk premium plus inflation expectations, 1987's unanticipated inflation will ultimately increase inflation expectations and consequently long rates.

STRATEGY: *The coming of unanticipated inflation from the dollar-inflation linkage promises a hot-house environment for gold. Retain long positions.*

— Steve H. Hanke

Chart 5

Cumulative increase in US prices following a 10% decline in the dollar			
Through	CPI, all items	CPI, services	PPI, all finished goods
12 months	1.59%	1.33%	2.18%
24 months	3.36%	3.90%	4.17%
36 months	4.26%	4.99%	5.17%
48 months	4.63%	5.30%	5.54%
∞ months	4.85%	5.42%	5.71%

Source: J. A. Whitt, Jr., P.D. Koch, and J. A. Rosensweig, "The Dollar and Prices: An Empirical Analysis," *Economic Review*, October 1986.

Note: These price increases are in addition to those that would have existed, if the dollar's exchange value had not changed.

Precious Metals

Gold

The correction from the \$446/oz. recovery high was more severe than we had originally anticipated but, significantly, held above our initial \$376/oz. support level (see *FC&CC*, Nov. 16, 1986). This point represents a full 66-2/3% retracement of the bull move that began in July.

Our gold valuation model (discussed in many of our previous issues) has turned impressively bullish (see Chart 6). Net external liabilities to foreigners, the result of a basic balance of payments deficit (despite a downward floating dollar) have been soaring and the momentum is accelerating: While the increase from June to July was \$12 billion, from July to

August net external liabilities increased \$16 billion, equivalent to a \$62/oz. rise in the gold valuation model.

STRATEGY: It is well nigh impossible for gold prices to collapse from these levels, given the upside momentum of our model. The enormous buildup in external liabilities portends a foreign exchange crisis of major proportions: Gold probably will soar well beyond its all-time high in the not-too-distant future.

Remain firmly long. Short-term traders, and only short-term traders, place protective stops at 376, basis nearby contract, close only.

Long-term investors should recognize this once-in-a-lifetime opportunity and overweigh their portfolios with gold.

Chart 6

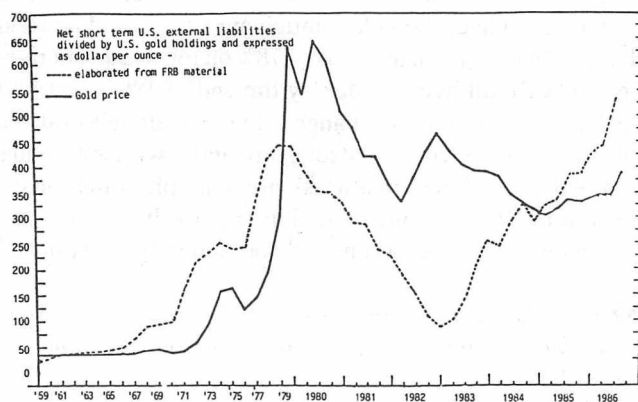
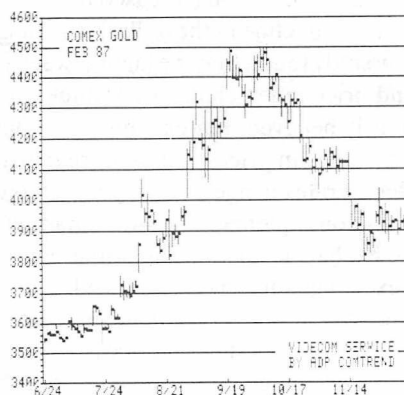


Chart 7



Silver and Platinum

STRATEGY: Having suffered a severe shakeout, both of the precious metals are ready to rejoin the bull market — on the coattails of gold.

Gold continues to outperform silver (Chart 8) and probably will do so until we are able to witness a significant pick-up in industrial demand for silver. Also, the recovery in the gold/platinum ratio in favor of the former probably will continue as the South African factor recedes.

Nevertheless, silver bugs can buy March '87 silver at market, risking a close below 5.25, and platinum lovers can buy April '87 platinum, risking \$459/oz., close only.

Chart 8

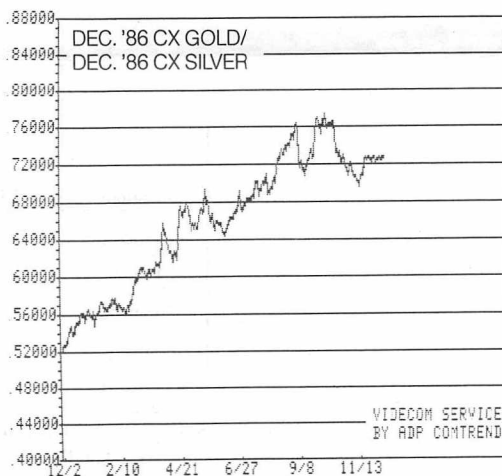


Chart 9

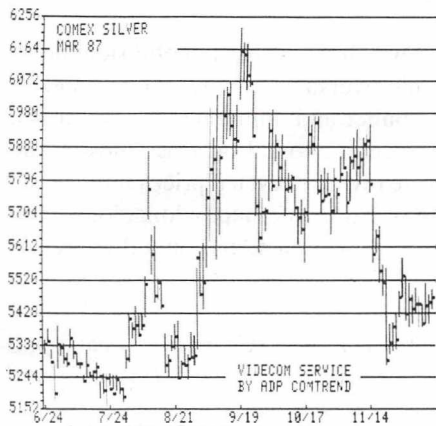


Chart 10

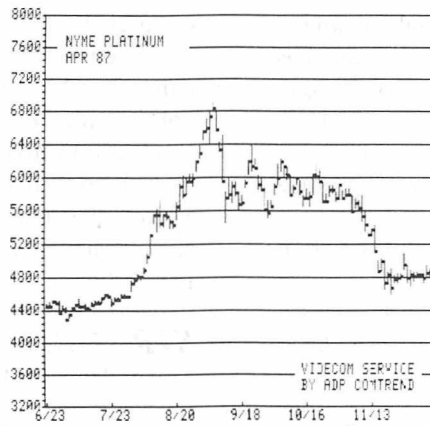


Chart 11

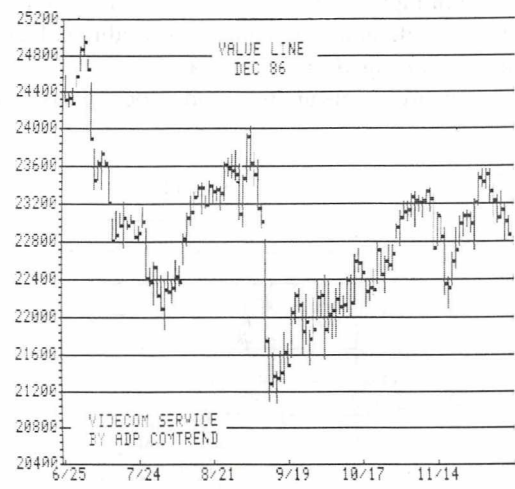


Stock Indexes

Narrow leadership, the paucity of new highs, and the weakness of the broad Value Line index (see Chart 12) compared with the more selective Dow Jones or even S&P 500, describe an exhausted market. Monetary conditions, on the other hand, are not conducive to a bear market. The stalemate will perhaps be resolved first in favor of a sharp and brief technical downward correction (15% to 25%) and later a broad advance led mostly by secondary issues. It is just too hard to call.

STRATEGY: *We are sidelined.*

Chart 12



Crude Oil

Hopeful comments emanating from the Geneva OPEC meeting to the effect that a 5% to 10% cutback has been well received by a majority of members raised crude prices by \$1.50/barrel. To the uninitiated, it would appear that the oil market can sustain itself merely on (OPEC) words: If OPEC could only meet every month, prices would stabilize and possibly recover to almost any level it desired!

The reality is altogether different. Optimistic statements do little to encourage final consumption. It may even be said that they are counterproductive in that they affect daily the conservation/substitution decisions of thousands of end-users: Concern about rising fuel prices (even though they are now low and are not necessarily rising) prolong the agony. What optimistic statements *do* cause is an increase in speculative

stock building. The more hope the market feeds on, the longer it takes for it to reach equilibrium: excess supplies in the hands of "speculators" compete with producers' output when hope starts to fade away.

The IEA estimates that during the third quarter, stocks rose by 2.2 million barrels per day (b/d). It estimates that at the end of 1986, stocks will reach 441.2 million tonnes, some 15.1 million tonnes higher than at the beginning of the year, making the *all-critical assumption* that stocks will be drawn down at an average rate of 0.9 million b/d in the last quarter of the year. In the "hopeful climate" of the last quarter, it is more likely that a new build-up of stocks took place, taking stocks perhaps as much as 7% to 8% above last year's level. Certainly, the American Petroleum Institute figures support

the thesis of a massive increase in stocks.

As control continues to pass from OPEC's hands to non-OPEC producers, and more particularly to speculators, the oil market becomes ever more vulnerable to disappointments. News that Kuwait and the UAE, two gentlemanly members of the cartel, are producing well above quota (a fact that has gone almost unnoticed because of Iran's shipping difficulties) or that Khomeini has died (implying an end to the Iran-Iraq war) can easily unleash a massive supply of oil on the market, wresting away from OPEC all semblance of production discipline.

Speculative sentiment aside, there is no substance to OPEC's 5% to 10% cutback scheme.

With prices in the mid-teens, it becomes nearly impossible to expect OPEC to adhere to quotas that were violated even when prices were near \$30. This can be attested by the fact that Kuwait and the UAE, the two wealthiest OPEC members, have been cheating on their October quotas.

All this time, final use or consumption has barely increased. The IEA, in a special report on Japan, points to a drop of nearly 10% in consumption of heavy fuel oil brought about by a switch to new non-oil power stations (the lagged effect of high prices). The decline in fuel oil matched an increase in demand for lighter oil products, leaving final demand unchanged since last year.

Oil producers are in a bind. Stocks, outside of their con-

trol, are rising and now stand well above year-earlier levels. Refining margins remain terrible (see Chart 13) as the glut in products worsens. Demand stagnates. And total revenues, at least for the large capacity producers, fall well below their optimum levels.

Sooner or later they will learn that hopeful statements can only add to chronic oversupply. Saudi Arabia and its cohorts must bite the bullet and announce the bad news: Production is to rise, prices are to fall. At least, most of the Gulf states will maximize revenues even if prices settle in the \$7 to \$8/barrel mark. Over time (perhaps a long, long time) some semblance of control will then, and only then, revert to OPEC.

STRATEGY: Nearest contracts (Chart 14) reveal a pattern of declining tops with the recent move to US\$16.25, still below the high registered in August and, before that, the highs recorded in May. For reasons discussed above, it is highly unlikely that the present attempt to goose prices higher will succeed any better than in the past.

Remain short. Keep in mind that the nearest contracts, due to massive oversupply, tend to trade at sizable discounts to the second position as we near expiration. These discounts allow us to roll over short positions, earning 15 to 50 points monthly, an extraordinary gift (it may average an annualized \$2 to \$3/barrel!).

Chart 13

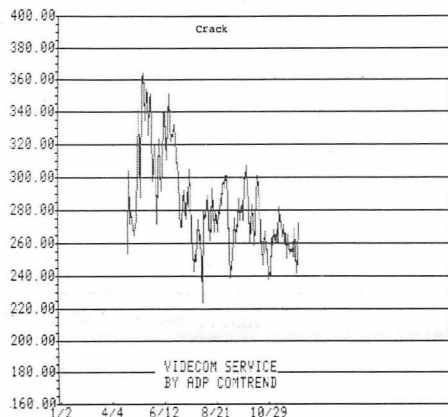
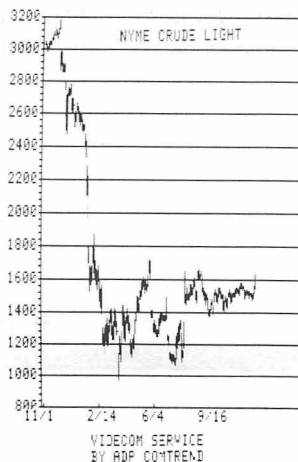


Chart 14



Currencies

A relatively broad trading range has developed for the critical \$/DM parity in recent weeks, bound by 2.03-1.95 DM. Weak economic statistics may prompt the Bundesbank to lower interest rates after the January elections, thus providing further support for the weak dollar. Nevertheless, we remain very skeptical about the dollar's prospects, in line with the views expressed in our interest rate section. Moreover, West German monetary authorities have expressed some concern that rapid monetary growth in West Germany may not give

them the necessary room to lower interest rates.

STRATEGY: The DM and its satellite currencies (Swiss franc and the stronger EMS currencies) are likely to strengthen further in coming weeks and months as the US current account gap fails to narrow satisfactorily.

Remain long March '87 DM, place stops at 48.50, close only. Remain long March '87 Swiss franc, place stops at 58.40, close only.

Chart 15

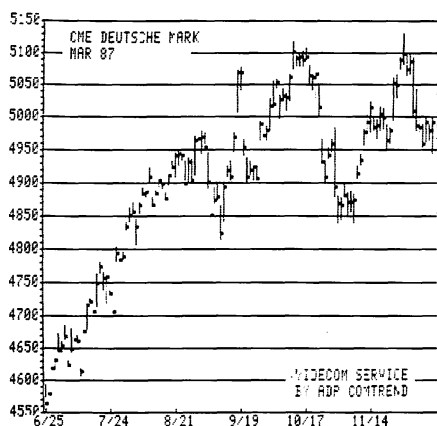


Chart 16

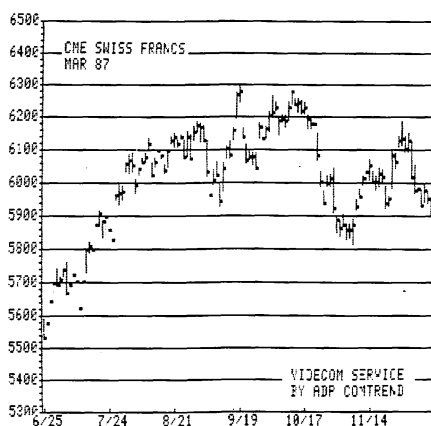
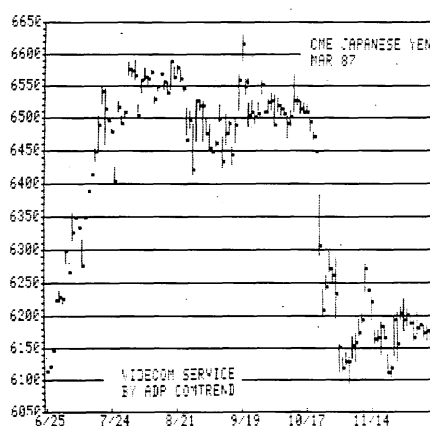


Chart 17



British pound

A significant policy change has taken place in recent weeks. On Tuesday, Dec. 2, Mr. Nigel Lawson, the UK Chancellor of the Exchequer said that the government was now committed to maintaining a firm exchange rate for the pound. In a speech to the Better Made in Britain organization, he said that the halving of the oil price earlier this year had produced a totally new situation: "In those exceptional circumstances I thought it only right to acquiesce in a somewhat lower exchange rate for Sterling... The important point is that the *adjustment has now happened* (our emphasis) and industry should plan on the basis that we still maintain a firm exchange rate."

There it is. Britain's monetary policy is in shambles. It is now prepared to abandon monetarism and revert to exchange rate targetting. We presume that the Chancellor had a cross rate of DM 2.82 in mind rather than a dollar/Sterling exchange rate. A successful defense of Sterling will require high and possibly rising interest rates. At least for some time, DM 2.82 is likely to hold.

STRATEGY: This policy change implies the following:

a) Based on forward rates, the cross-rate is substantially below DM 2.82 (see Chart 18). We will therefore liquidate the very successful spread short BP/long DM or long SF, first recommended in our FC&CC of June 22, 1986.

Our spreads, requiring \$7,500 margin (three BP contracts for every two DM contracts) and \$4,500 margin (two BP contracts for every SF contract) made a profit of \$15,925 in the BP/DM spread and \$8,350 in the BP/SF spread.

b) Maintain short positions in the LIFFE three-month Sterling deposit contract and the LIFFE long gilt contract (see Charts 21 and 22).

c) Maintain short position on the LIFFE FTSE 100 (the British equivalent of the S&P 500 stock index) contract. Place stops at 170, basis March '87. This recommendation was regrettably omitted in our last FC&CC but was given over the Hotline Update of Nov. 18.

Chart 18

Implied Cross Rates

	DM	SF
Dec. 86	2.8761	2.4142
Mar. 87	2.8298	2.3661
Jun. 87	2.7791	2.3246
Sep. 87	2.7449	2.2861

As at Dec. 12th, 1986

Chart 19

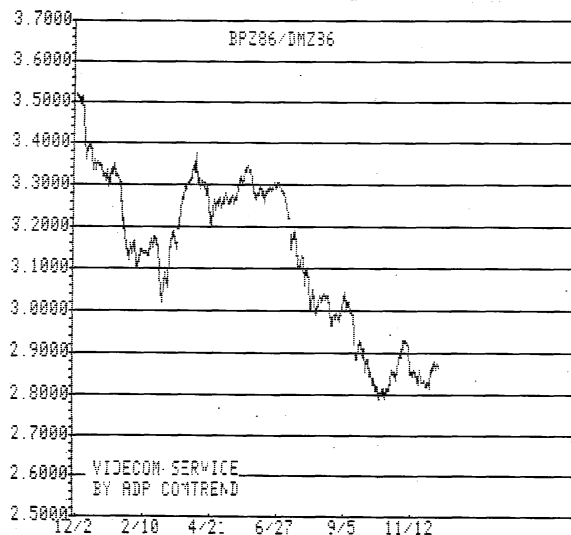


Chart 20

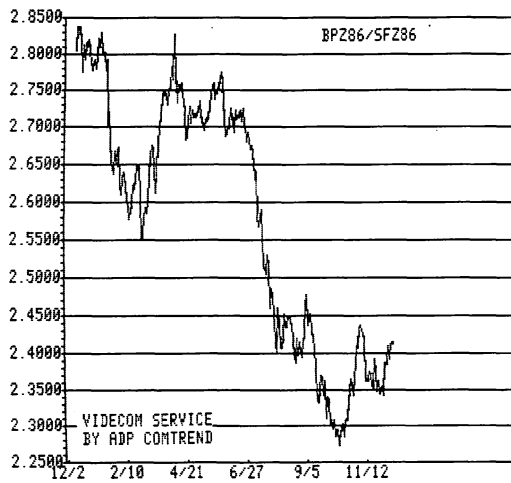


Chart 21

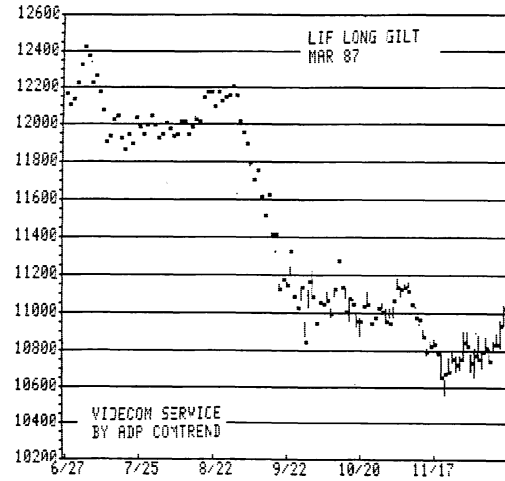


Chart 22

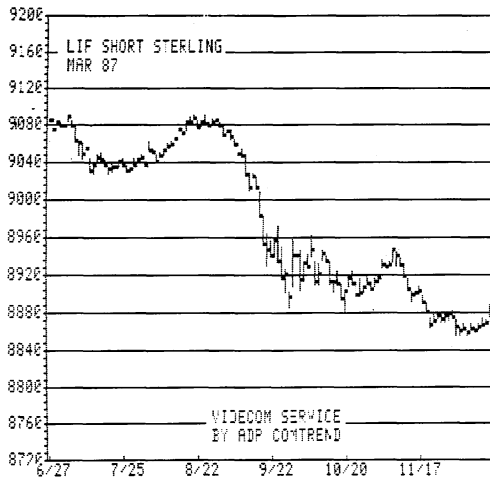
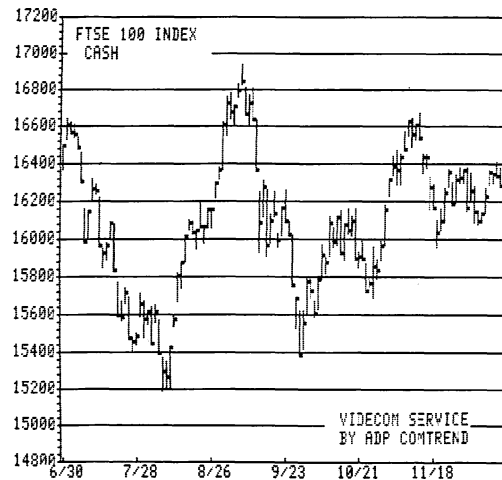


Chart 23



Canadian dollar

Although Canada's trade position, and consequently its current account position, continues to deteriorate (a deficit of C\$2.2 billion for the third quarter compared with a deficit of C\$2.0 billion in the second quarter), net official monetary movements, the best measure of the overall balance of payments, has been showing a slight surplus for the past two months (even factoring out the issue of our US\$900 million of three-month T-bills in New York).

The reason? Principally, large Japanese buying of Canadian bonds, taking advantage, presumably, of the higher interest rates prevailing in Canada (see Chart 24). It is difficult

to estimate the duration and/or magnitude of this inflow, which at this time is acting as an offset to the deficit on current account. What is clear is that the current account deficit, if it persists, will sufficiently erode confidence in the country and its currency that the capital inflow will cease and then revert to an outflow.

STRATEGY: *The stronger than expected capital inflows forced us to reconsider our near-term view of the Canadian dollar. On Dec. 5 (see Hotline Update) we advised closing our short positions at market (which includes liquidating the sale of at-the-money calls). Remain sidelined.*

Chart 24

Net Trade in Outstanding Canadian Bonds With Japan and All Other Foreign Countries (Net Sales + / Net Purchases-)

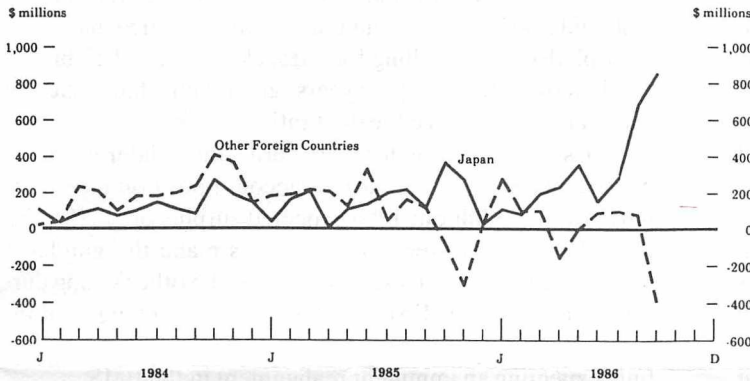
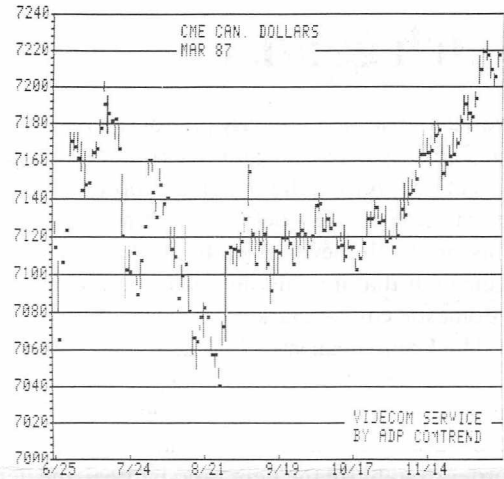


Chart 25



Friedberg Capital Markets

Foreign Currency Bonds

As if by spontaneous combustion, the liberalization of the international financial markets has led to an enormous demand for high quality credits denominated in a multiplicity of currencies. Catering to this demand, Friedberg Capital Mar-

kets offers investors a select number of foreign currency bonds, which are issued by both sovereign and blue-chip credits. These issues, listed on various European exchanges, trade principally out of London and New York. In addition, should you be interested in any *other* Eurobond or Yankee bond, don't hesitate to call us.

Chart 26

CURRENT INVENTORY

Date: December 15, 1986

We offer the following Bonds, subject to change without prior notice: Minimum amount \$5,000 U.S., (\$7,000 CDN.)

ISSUER	COUPON/MAT.	BID	OFFER	CURRENT ANNUAL YIELD TO MAT.	CURRENT COUPON PERIOD
NEW ZEALAND DOLLAR DENOMINATED					
COCA COLA Finan. Corp.	18% 16/6/89	103 3/4	104 1/2	15.52	16/6/86-16/6/87
KONDA INT'L	16 3/8% 20/9/89	101 3/4	102 1/2	15.10	20/6/86-20/9/87
KONDA INTL	16% 28/5/90	99 3/4	100 1/2	15.52	26/11/86-28/5/88
TOURIST HOTEL CORP. OF N.Z. (zero coupon) 4/6/93 (govt. guarantee)		39 1/2	41 1/2	14.56	matures 4/6/93
MELLON BANK	16 1/2% 15/9/88	100 1/2	101 1/4	15.23	15/9/86-15/9/87
WELLS FARGO Semi	16 1/8% 12/5/89	99 3/4	100 3/4	16.33	12/11/86-12/5/86
DEUTSCHE MARK DENOMINATED BONDS					
REP. PORTUGAL	6 5/8% 19/6/94	100 3/4	101 1/2	6.36	19/6/86-19/6/87
BELGIUM	5 1/2% 29/4/96	93 3/4	94 1/2	6.29	29/4/86-29/4/87
QUEBEC HYDRO	5 1/2% 1/5/96	94 3/4	95 1/2	6.14	1/5/86-1/5/87
SWISS FRANC DENOMINATED BONDS					
Govt. of AUSTRALIA	5% 30/10/98	101 1/2	102 1/4	4.75	30/10/86-30/10/87
JAPANESE DENOMINATED BONDS					
Govt. of CANADA	5 5/8% 23/7/93	99.90	100.65	5.50	23/7/86-23/7/87
U.S. DOLLAR FIXED COUPON NOTES					
CHRYSLER	9.30% 1/8/94	102 1/2	103	9.05	1/11/86-1/2/87
U.S. DOLLAR DENOMINATED FLOATING RATE NOTES					
ISSUER	MAT.	PRICE	CURRENT COUPON	NEXT COUPON DATE	
SANTA BARBARA SAVINGS & LOAN (fully collateralized)	18/12/95	1/8% over 3 months LIBOR (quarterly) 99.76	6 3/16%	18/12/86	
LINFIN SAVINGS & LOAN (fully collateralized)	14/11/95	1/8% over 3 months LIBOR (quarterly) 99.53	6%	17/2/87	
WELLS FARGO	3/4/2000	1/8 over 1 month LIBOR (adjusted monthly) 99.80	6%	17/12/86	

The Exotics

Dutch guilder

It would appear that the easy part of the fiscal adjustment is over. The drop in oil and gas prices reduced government revenues and increased the deficit to approximately 8% of net national income. The deficit is still nearly two percentage points up on the level of early 1980 when the Minister of Finance felt that it could no longer be financed properly in the domestic capital market.

The Damoclean sword of the public sector is still hanging over the Dutch economy; total public debt is still rising as a percentage of national income and is likely in the not-too-distant future to undermine confidence in the government. In order to stabilize the debt ratio by 1990, the deficit in that year would have to be equal to 3.5% to 4% of national income, which would necessitate cuts in the amount of at least 20-25 billion guilders. It is difficult to know precisely what impact

this cutback would have on the actual growth of national income, and thus it may underestimate the required austerity. It should also be pointed out that the large political parties in their platforms are calling for cutbacks of only 12-17 billion guilders over the next four years, an amount that is clearly insufficient to stabilize the debt ratio.

Despite these long-term concerns, the guilder is underpinned by a very strong current account position (1985 surplus of US\$5.3 billion; 1986 expected surplus of US\$6.8 billion). Higher short-term interest rates make the guilder a relatively attractive investment vis à vis the other strong currencies and even the DM. This has justified our long position to date, and we see no reason to change this view even while fully expecting an imminent realignment in the EMS.

STRATEGY: Remain long vis à vis DM and US dollars.

Chart 27

YEAR	DUTCH GUILDER PER U.S. DOLLAR (PERIOD AVG.)	BASKET			
		U.S. 1970 =1.00	U.S. 1977 =1.00	U.S. 10% 1970 =1.00	U.S. 15% 1977 =1.00
1967	3.5960	0.9925	1.7581	1.0543	1.5203
1968	3.6060	0.9996	1.7707	0.9917	1.4299
1969	3.6240	0.9880	1.7501	0.9731	1.4032
1970	3.5970	1.0000	1.7714	1.0000	1.4420
1971	3.2581	0.8783	1.5559	0.9209	1.3280
1972	3.2265	0.8338	1.4771	0.9340	1.3468
1973	2.8245	0.7180	1.2719	0.8652	1.2476
1974	2.5065	0.6452	1.1429	0.7730	1.1147
1975	2.6885	0.6839	1.2115	0.8592	1.2390
1976	2.4570	0.6977	1.0765	0.7171	1.0340
1977	2.2800	0.5645	1.0000	0.6935	1.0000
1978	1.9690	0.5037	0.8922	0.6727	0.9700
1979	1.9055	0.5202	0.9216	0.7409	1.0683
1980	2.1295	0.6197	1.0977	0.9172	1.3226
1981	2.4685	0.7432	1.3166	0.9466	1.3650
1982	2.5245	0.7914	1.4019	0.9206	1.3275
1983	3.0645	0.9278	1.6436	0.9959	1.4360
1984	3.5495	1.0854	1.9227	1.0571	1.5243
1985	2.7720	0.8579	1.5197	0.8224	1.1860
1986 (1Q)	2.6130	0.8197	1.4520	0.8883	1.2809
1986 (2Q)	2.4800	0.7743	1.3717	0.8756	1.2626

Above 1.00 = undervalued
Below 1.00 = overvalued

Chart 28

Year	Foreign Assets (Min US\$)	CURRENT ACCOUNT		CUMULATIVE 12 QTR. Current Account (Min US\$)
		A\$ % of GNP	%	
1970	3,458	-1.51		-355
1971	4,622	-0.28		-439
1972	5,767	2.94		762
1973	7,215	3.99		3664
1974	9,000	3.11		5900
1975	10,165	2.40		6628
1976	10,984	3.00		6939
1977	11,004	1.00		5843
1978	13,164	-1.23		2163
1979	13,744	0.05		-491
1980	13,773	-0.62		-2662
1981	15,470	0.26		-596
1982	15,736	2.98		+3419
1983	16,508	3.86		+9579
1984	22,090	5.30		+15726
1985	28,618	4.29		+16976
1986 (2)	-	-		+16821

Chart 30

SPOT	1 - Month	3 - Month	6 - Month	12 - Month
2.2870-	2.2865-	2.2858-	2.2833-	2.2770-
2.2860	2.2877	2.2871	2.2848	2.2795

Chart 29

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

Reserves * + Previous 12-months curren Account *** = 35,900
(Reserves + 12-months C/A) / MI ** = 35900/32038 = 112%
(Reserves + 12-months C/A) / Broad Money ** = 35900/97178 = 36.9%

*As at Aug. 1986** Dec. 1985 *** 1986 Estimated

Figures in millions of U.S. Dollars

	MI (Converted to U.S. Dollars)	Broad Money (Converted to U.S. Dollars)
1975	17552	41971
1985 Dec.	32038	97178
% Increase (decrease)	82.5%	131.5%
Corresponding % increase in the United States	115%	143%

(a) 1985 Imports as percentage of GNP 45.65
(b) 1976 - 1985 Imports as percentage of GNP 40.18
1985 /1976 - 1985 average) = (a)/(b) = 113.61%

Source: IFS

Venezuelan bolivar

The more things change, the more they remain the same. Venezuela has stepped further into the mud of interventionism; the Lusinchi government has been trying desperately to deny the realities of the massive drop in income arising from the drop in oil prices. A simple unified exchange rate would have been the cleanest solution; instead Lusinchi entered the maze of exchange controls and has as yet not been able to exit. In fact Venezuela now suffers from at least five different rates of exchange:

1. 7.50 bolivars to the dollar for essential imports, including food, medicine, shoes and clothing.
2. 7.50 plus a 4.50 bolivar premium for private debtors, for repayment abroad of interest and principal conditional on some rescheduling provision, details of which have as yet not been forthcoming.
3. 14.50 bolivars to the dollar for public companies participating in the government's public sector rescheduling.
4. A restricted free market rate now around 21.50 bolivars per dollar for travel and nonessential imports.
5. An unrestricted black market for capital flight, probably in the area of 25-26 bolivars per US dollar.

As if this were not enough, the central bank will tax its

oil and iron industry exports by buying their dollars for 7.50 bolivars.

This multiple exchange rate system is expected to generate income to the government of 40 billion bolivars per year. We might add however, that it could generate at least that much in capital flight (there seems to be no limit to the stupidity of politicians).

Before the recent devaluatory scheme, the free market had reached 26.90 bolivars to the dollar. Subsequently, the free market rate receded to 21.50, a logical reaction to the devaluation experienced in the more overvalued range in the currency.

In spite of the poor prospects for oil, we still believe that a single unified rate could be feasible somewhere between 15 and 19 bolivars to the dollar, given the country's large reserves, balance on current account, and relatively conservative monetary policy. Incoherent economic policies lead to capital flight, which at this time is the single most unfavorable development in the external sector.

STRATEGY: In our last coverage of the bolivar (FC&CC, March 23, 1986) we recommended a neutral position in view of the steepness of the forward discounts, and the relative undervaluation of the free market rate.

We still adhere to those views.

Chart 31

YEAR	VENEZUELAN BOLIVARS PER U.S. DOLLAR (PERIOD AVG.)	U.S.	
		1970 =1.00	1978 =1.00
1967	4.45	0.9152	0.9239
1968	4.45	0.9423	0.9514
1969	4.45	0.9686	0.9779
1970	4.45	1.0000	1.0096
1971	4.44	1.0101	1.0198
1972	4.40	1.0057	1.0153
1973	4.30	1.0016	1.0113
1974	4.28	1.0215	1.0313
1975	4.28	1.0132	1.0229
1976	4.28	0.9972	1.0067
1977	4.29	0.9851	0.9945
1978	4.29	0.9905	1.0000
1979	4.29	0.9800	0.9894
1980	4.29	0.9155	0.9242
1981	4.29	0.8713	0.8796
1982	4.29	0.8421	0.8502
1983	9.90	1.8866	1.9048
1984	12.65	2.2411	2.2626
1985	14.40	2.3355	2.3580
1986 (1Q)	18.30	2.8074	2.8544
1986 (2Q)	18.58	2.8449	2.8723
1986 (3Q)	19.95	2.9260	2.9541

Above 1.00 = undervalued
Below 1.00 = overvalued

Chart 32

Year	Foreign Assets (Min US\$)	CURRENT ACCOUNT		CUMULATIVE 12 QTR. Current Account (Min US\$)
		As % of GNP	%	
1970	899	-0.09		-518
1971	1,389	0.00		-335
1972	1,612	-0.07		-216
1973	2,387	5.34		756
1974	6,413	22.53		6536
1975	8,807	7.85		8808
1976	7,961	0.08		8185
1977	8,081	-8.78		-754
1978	6,701	-14.61		-8660
1979	8,124	0.07		-8564
1980	7,383	7.94		-657
1981	8,870	5.97		9078
1982	9,708	-6.40		4427
1983	5,163	15.60		4482
1984	6,116	20.06		5599
1985	6,229	11.23		12768
1986 (1)	4,604	-		-
1986 (2)	4,894	-		-

Chart 33

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

Reserves * + Previous 12-months curren Account ***= 13526
(Reserves + 12-months C/A) / ML ** = 13526 / 5170 = 261%
(Reserves + 12-months C/A) / Broad Money ** = 13526 / 10911 = 124%
*As at Aug. 1986** June 1986 *** 1986 Estimated

Figures in millions of U.S. Dollars

	ML (Converted to U.S. Dollars)	Broad Money (Converted to U.S. Dollars)
1976	6314	11338
1986 June	5170	10911

% Increase (decrease) (18.1) (3.7)

Corresponding % increase in the United States 110.4 122.4

(a) 1985 Imports as percentage of GNP 28.39
(b) 1976 - 1985 Imports as percentage of GNP 22.45
1985 / 1976 - 1985 average = (a)/(b) = 126.45

Source: IFS

Chart 34

SPOT	1 - Month	3 - Month	6 - Month	12 - Month
21.65-	21.90-	22.40-	23.25-	Not Available
21.75	22.10	22.75	24.25	

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 2.0100)</i>
Australian dollar	.6590-.6595	.6442-.6451	.6055-.6070	Remain long; stop 6250	Remain long; stop 6250, basis US
Belgian franc	42.08-42.13	42.21-42.30	42.61-42.81	Remain long	Remain long
Danish krone	7.6400-7.6450	7.7000-7.7810	7.9275-8.0375	Neutral	Remain short
Greek drachma	142.25-142.35	147.25-149.50	160.25-170.25	Neutral	Remain short
Italian lira	1401-1403	1402-1404	1406-1409	Remain long	Neutral
Kuwaiti dinar	.29430-.29440	.29490-.29530	.29650-.29800	Neutral	Remain short
Malaysian ringgit	2.5940-2.5960	2.6030-2.6100	2.6440-2.6960	Neutral	Neutral
New Zealand dollar	.5110-.5120	.4915-.4935	.4490-.4530	Remain long	Remain long
Norwegian krone	7.5925-7.5975	7.7905-7.8015	8.3325-8.3525	Remain long	Neutral
Portugese escudo	150.00-150.30	153.25-154.55	157.50-166.80	Neutral	Neutral
Saudi Arabian riyal	3.7500-3.7510	3.7725-3.7795	3.8225-3.8310	Remain short	Remain short
Singapore dollar	2.1940-2.1950	2.1818-2.1835	2.1510-2.1620	Remain short; stop 2.1400, basis spot	Remain short; stop 4.2700, basis spot
Spanish peseta	136.25-136.40	138.10-138.55	142.95-143.90	Neutral	Neutral
Swedish krona	6.9675-6.9725	7.0250-7.0385	7.1740-7.1890	Remain long	Neutral

Explanatory Notes

*Indicates change in recommendation from last issue

Currency expected to firm against both currencies.

Currency expected to strengthen against US \$ and weaken against DM.

Currency expected to weaken against both major currencies.

Currency expected to weaken against US \$, but strengthen against DM.

Term used to liquidate short position but does not imply a new buy recommendation

Term used to indicate sale advice of previous long position, but does not imply a new short sale recommendation.

Buy	Buy
Buy	Sell
Sell	Sell
Sell	Buy
	Cover
	Liquidate

Hotline Update

Tuesday, Nov. 18: The market letter will be mailed this evening. Lower market letter stops on December S&P contracts to 245.00, good anytime. One omission in the market letter: In discussing the British market, we recommended selling long gilt and short sterling contracts on the LIFFE. We omitted to mention the opportunity to sell the FTSE 100 stock index contract.

Friday, Nov. 21: 1) We were stopped out of our December S&P positions as per our revised stop, issued Tuesday, of 245.00, basis December, good anytime. Please note that the market letter erroneously suggested selling December '87 S&P, which was obviously meant to be December '86. We apologize for the typo.

2) We recommended on Tuesday to short the FTSE 100 stock index contract. Place stops at 167.00, good anytime.

Tuesday, Nov. 25: No changes or new recommendations.

Friday, Nov. 28: No changes or new recommendations.

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

Friday, Dec. 5: Two new recommendations:

- 1) Cover all short Canadian dollar short positions at the market.
- 2) We have a new suggestion: Sell March '87 Eurodollars and March '87 T-bonds at the market. Place stops at 94.25, close only and 100.31, close only, respectively. No other changes or recommendations.

Tuesday, Dec. 9: As a courtesy to those who missed our review on Friday, there were two new recommendations:

- 1) Sell March '87 Eurodollars and March '87 T-bonds at the market, placing stops at 94.25 and 100.31 respectively.
- 2) Cover all short Canadian dollar positions at the market.

Friday, Dec. 12: As per our hotline recommendation of Friday, Dec. 5, we are now short March T-bonds at approximately 9830 and short March Eurodollars at approximately 9403, with stops at 100.31 and 9425, respectively, close only. We have also liquidated our short positions (in the Canadian dollar) at approximately 7171, basis June. No other changes or new recommendations.

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