

Photographs: Merry Alpern

Aching Greenback

Al Friedberg Sees a Weaker Dollar, Stronger Gold

It's been nearly two years since Al Friedberg shared his views of the world's markets with us. At that time, the head of the Toronto-based broker Friedberg Mercantile Group made what seemed like outrageous predictions: \$10 a barrel oil, the pound-sterling dropping to parity with the dollar, the greenback "sniking" to 3.40 Deutschemarks. All, of course, proved remarkably on target. Accordingly, with the commodity and currency markets once more in turmoil, we asked Al back to explain what's hap-

pening and what he thinks is likely to happen. Again, he offered some distinctly non-consensus opinions. To find out what they are, read on.

—Randall W. Forsyth

BARRON'S: *Al, you've been through lots of cycles, including the current bear market in commodities. Do you think that's just about over?*

FRIEDBERG: I think so. I think the very pronounced weakness of the dollar

is going to influence the commodity price level.

Q: *It hasn't yet. The Commodity Research Bureau futures index hit a new low for the cycle a few days ago.*

A: You're right, it hasn't yet. But I think it will at some point. I don't know exactly when. On the one hand, you have contractionary forces exerting an influence on the economy, deflationary forces, that is. On the other hand, you

have dollar weakness and very aggressive monetary ease, a combination which will eventually overcome the weakness.

Q: *A lot of people expected that to happen a long time ago. Why hasn't it?*

A: We still are experiencing a delayed reaction to the earlier strength of the dollar. Until about early '85, that was a bearish factor for commodity prices. Since that time, business conditions have become a lot softer, so that you still have a delayed reaction to that process, and this is why commodity prices have not yet firmed up. The individual weakness of oil also has had a depressing effect of sorts on the CRB futures index. The cash commodity price index has shown some strength in the past few months.

Q: *In general, though, the commodities bear market has reflected a huge glut in almost everything.*

A: Yes.

Q: *But you see that changing? Or, at least that seems to be the implication in what you just said.*

A: What's happened is that the U.S. price level was artificially high compared to the world market and the U.S. has changed its policies. It is bringing domestic prices in line with world prices in order to stimulate exports. I think that process will be completed soon, at which point you will see the commodities market bottom and turn up.

Q: *How much will that reflect U.S. agricultural policies and how much the decline in the dollar?*

A: I think agricultural policy, in the main.

Q: *The lower dollar won't hurt.*

A: It will help. But I should say one thing. We are reacting today—and have been for the past three or four years—to very high prices in real terms that took place in the late 'Seventies throughout the economy.

Q: *So there's a lag effect. On that basis, to state the obvious, today's low commodities prices should begin to exert an impact.*

A: There's no question. At some point the relatively low level of commodity prices should begin to restrict output.

Q: *Are you saying that ultimately, then, as output is restricted and supply shrinks in one commodity after another, we'll suddenly find ourselves concerned about a revival of inflation?*

A: I see a strong return to inflation. I think that maybe by late this year we are going to have some kind of a pick-up in inflation, but I can't really tell exactly when. Again, if we're looking at commodity prices, they're only one factor. We do have a large inflation in the service area and it will be a major influence on prices in the next few years.

Q: *Don't service prices tend to lag other prices—especially raw commodity prices?*

A: I'm not sure that holds true. In any case, right now you have areas in the economy that are highly inflated. For instance, real estate is still highly inflated, and in some cases very strong. So during this period of what people call disinflation or deflation you have had house prices in the Northeast going up 20%, 30% in the last year, and 25% or so in California. You have had art prices going up very, very strongly in the past year or two. You have had many services going up in price, too.

Q: *But, Al, you can't blink at the fact that prices at the retail level have been flat over a 12-month period.*

A: Energy has had a large influence

there. I think without energy you would probably have something like a 3% or 4% rate of inflation, which seems to be about the core rate of inflation the past few years. I don't think that we've gone much below that.

Q: *So, it's from a basic rate of 3%-4%, that you see inflation accelerating.*

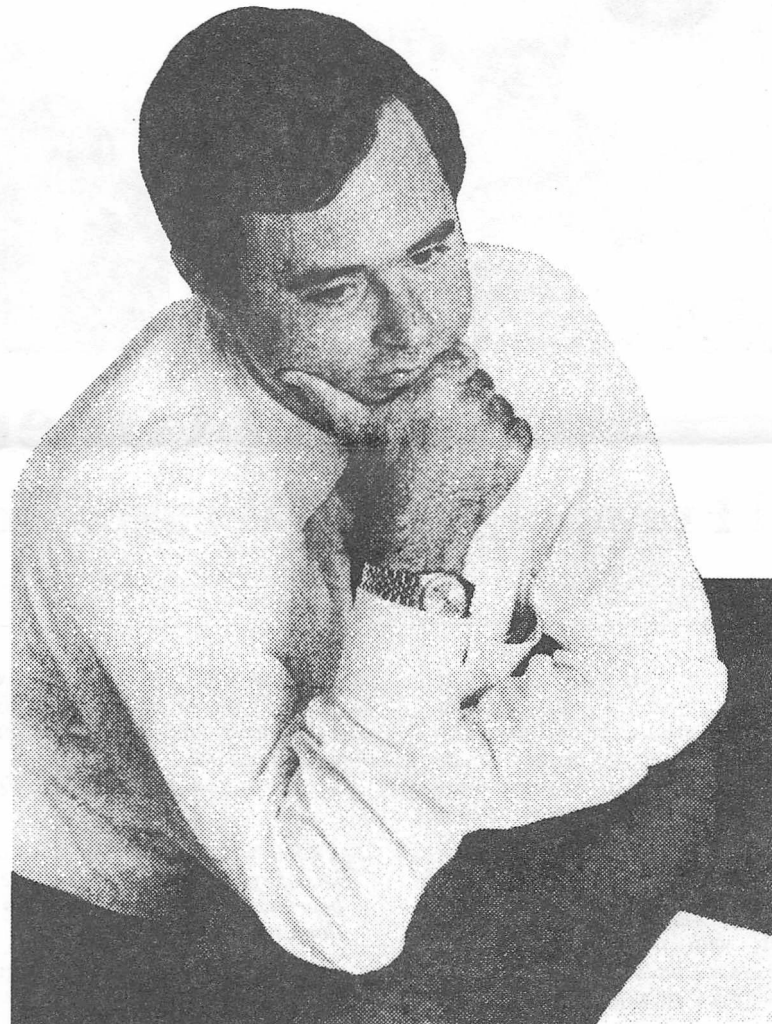
A: Yes.

Q: *Barron's readers will recall you were a ferocious bear on oil prices when they were high. Where do you see crude going and what effect do you think that will have on inflation?*

A: I think crude prices are still in the middle of a bear market. I expect them to reach \$5 a barrel or less. But the decline will have a diminishing influence on prices generally because the bulk of the plunge has already taken place.

Q: *You mean the moves that took crude from \$30 to \$10 a barrel?*

A: Right. Going from \$10 to \$5 a barrel will have a lesser influence on overall prices.



Q: It seemed for a while that crude futures and North Sea prices were rebounding. Was that just an uptick in the continuing bear market?

A: Yes. There was a little bit of recovery in advance of the new OPEC meeting on the possibility that something might come out of that meeting. But actions speak louder than words and we see that OPEC production is rising every day. I believe the Saudis were in a box. In mid-'85 they saw that they were the only ones that were sticking to their quotas. They first affirmed that they had a right to produce 4.3 million barrels a day because that was the agreement. And in early '86, the Saudis even stated that they had a right to a given percentage of OPEC output. So that if their percentage was 17%, let's say—and I don't recall the numbers exactly—they would maintain that percentage.

Q: If everybody cheated, they had a right to cheat as much as everybody else.

A: What they're basically doing is moving to higher levels of production as unobtrusively as possible.

Q: Well, the market has certainly taken note of it. Do you see this drop to \$5 a barrel as the blow-off? And what effect do you think it will have on non-OPEC supplies?

A: For one thing, I don't expect a "V" type of bottom. I don't think that we're going to hit a certain level and then bounce back to \$10 or \$15 or \$20. I believe that oil prices for the next decade, at least, are going to remain very, very low, probably between \$5 and \$8. Needless to say, if we have a massive inflation, those numbers will be adjusted upward, but oil will remain very depressed. I don't expect a price recovery of any significance. During that period, OPEC production will go up to its maximum and we're going to see production of 30 million or 32 million or 33 million barrels a day.

Q: And that compares with what, currently?

A: Currently about 19½-20 million. We're going to see a pre-empting of the market that some of the non-OPEC producers have taken away from OPEC.

Q: Such as Britain and Norway?

A: Britain and Norway. As for the Russians, it is difficult to say because they don't have a very well-defined cost structure. But you're going to see market share being taken away from many U.S. producers, many Canadian producers. You're going to see countries such as Nigeria and Indonesia move to their maximum production levels.

Q: Where does that leave Mexico?

A: Mexico will produce oil because it's relatively cheap to produce there and because they need the foreign exchange.

Q: Does that mean a lot of U.S. domestic production will be shut in?

A: Yes. Over the years, I wouldn't be surprised if more than half of U.S. production would be shut in. Now what could change the picture a little bit is if the U.S. imposes some kind of an import tariff.

Q: What do you think the odds are on that?

A: I think they're good.

"The U.S. is bringing domestic prices for commodities in line with world prices to stimulate exports. The process will be completed soon, at which point you will see the market bottom and turn up."

Q: Is that because you think Bush will be in the White House?

A: I think we'll have a tariff or its equivalent no matter who comes in after Reagan. A Democrat, for sure, or even a Bush, for instance, would change current policy, especially if prices are low for many years and production is dropping. If U.S. production goes from nine million barrels a day down to 4½ million barrels a day, you're going to get a tremendous outcry. And that will create an even more bearish picture for the world oil market.

Q: Why is that?

A: Because as U.S. production increases, those extra few million barrels a day that were coming into the U.S. to satisfy demand now will have to find another outlet in the world market. In the process of seeking such an outlet, the crude barred from the U.S. will push prices down even further. So you will see a tremendous, tremendous downward pressure on world prices with the imposition of a U.S. import tax.

Q: Cheap oil, you're saying, will not prove a deterrent to the return of inflation.

A: Well, as I said before, I don't think that the drop from \$10 to \$5 a barrel is going to make as much a difference as the drop from \$28 to \$10. At the same time, the price of other commodities will begin to rise, as supply and

demand conditions grow into better balance. And the continuous drop of the dollar will make inflation pick up in many other areas.

Q: How much lower will the dollar go?

A: The dollar is still in a bear market, and it can go a lot lower. We expect a deepening recession in the U.S., which possibly began in the last couple of weeks or couple of months, and will become more evident in the next few months. The Fed will become extremely frustrated because it will be the only one fighting this recession. The fiscal side of the economic picture is actually contracting a little. The deficit is expanding only as a result of cyclical factors; it isn't

like 1981, where the deficit went from 1% of GNP to maybe 5%, and had a major impact on the economy. As the Fed is left to revive the economy, they will push harder and harder on money, and that will cause the dollar to drop faster and faster. We saw the first signs of this sequence this month when the Fed lowered the discount rate, but the action was not followed by any of the other central banks.

Q: Given the fact that the Japanese and West German GNP numbers for the first quarter were actually negative, how do you explain their reluctance to ease along with us?

A: I think that the Germans and the Japanese understand a little better—and perhaps Volcker, does, too, if not the entire Federal Reserve—the function of monetary policy. I think that they, as well as the Swiss, understand that monetary policy cannot affect their real output. As a result, they are not about to proceed and stimulate their economies via monetary policy. By contrast, in the U.S. you have people like Johnson and Angell and Seger, who believe strongly that an accommodative posture by the Fed will help the economy. We have seen that this is not true, because for the past 18 months the Fed has been extremely accommodative, yet the economy has been very slow.

Q: One also could argue that monetary policy's role is to maintain stable prices,

and that the Fed has been trying, without success, to find the Fed funds rate that allows prices to stop falling.

A: I disagree. Because from the statements made in the last few weeks, they don't talk about falling prices as a justification for cutting the discount rate. They're talking about a sluggish rate of economic growth.

Q: *Declining commodity prices were specifically cited for cutting the discount rate last time.*

A: Well, CPI is not negative; CPI is positive. And what's really bothering them is the fact that the economy is sluggish. And what they're saying is, as long as the economy is sluggish and as long as prices are not moving up, we have enough room to increase the money supply even more rapidly. But they have the constraint of foreign exchange. And when the dollar drops precipitously, it's inevitable that prices will have to rise. We see the price of gold is very firm, very solid, torn between falling commodity prices and the falling dollar, and, basically, moving up very slowly since early 1985. And I think that the gold market will be the barometer showing how deep our inflationary problem really is. We think that early 1985 was the bottom of the gold market at \$280 an ounce. I don't think we'll ever see that price again in our lifetime.

Q: *But the gold market in recent years has been more asleep than awake.*

A: The gold market has not yet had the courage to rise in the face of commodity weakness. We are telling clients it will overcome the cost of carry, so we think anybody who buys gold for six months' delivery or 12 months' delivery and pays the small premium for it, which is no more than about 7% per annum, will come out ahead. And that's the minimum expectation. We think that gold has become so cheap in international terms, to Japanese, Swiss, German investors, because of the sharp rise of their currencies, that it's inevitable that we're going to see a massive explosion of prices in the next two or three years. I think that you're beginning to see a large amount of demand coming from these countries. For instance, Japan is importing over 350 tons of gold this year—part of it is for their new gold coin. I believe that this is a phenomenon that will pick up momentum in the next few months or few years, and you will see gold prices going up, on genuine investment demand coming from these countries.

Q: *In other words, the Japanese will start investing their trade surplus and savings surplus in gold instead of Treasury bonds?*



A: Exactly. With the dollar going down, they now have tremendous losses in their bond portfolio. At some point they're going to give up and say, listen, we trusted the Americans for a long time. We trusted them when they said 200 yen to the dollar would be sort of the stopping point. At 190, the Japanese government told the Japanese insurance companies, you can buy U.S. bonds and don't worry, the rate won't go below 180. It's gone to 155 as of this morning. And Japanese investors in U.S. securities are now bloodied and losing enormous amounts of money.

Q: *That's assuming they didn't hedge at all.*

A: No, the insurance companies and most of the buyers of Treasury bonds in Japan are not hedgers. They bought them for the yield, which was three or four percentage points higher than Japanese bonds. If they would have hedged, they would have lost the interest-rate advantage.

I think at some point, they're going to decide to dump these bonds and buy something that is cheap, genuinely

cheap, and that looks like it's going higher. And that is gold.

Q: *Is that happening in European countries?*

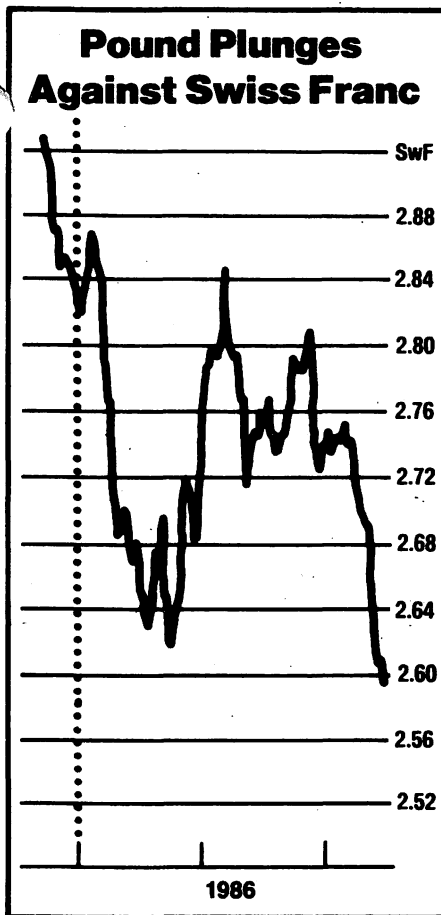
A: I see that happening in Germany. I see the same thing happening in Switzerland. I see that happening in any one of those countries that has had a rising currency for the past year or year and a half.

Q: *What evidence do you have?*

A: The fact that gold has not dropped along with the other commodities in the U.S. In fact, it has gone up from \$280 to \$350, while everything else has been going down. That's telling me that there is, in fact, already substantial cash buying. Which can become a flood, at some point.

Q: *Hasn't gold ridden on platinum's coat-tails?*

A: No. The platinum market is too small. The platinum futures market's total open interest is 17,000 contracts. An attractive market, we like it, but it's



extremely small. It has no bearing on large buyers of precious metals. Whether it be the Sultan of Brunei or some sheik or whoever it is that has large amounts of money to invest in precious metals, he would not be looking at platinum, he would be looking at gold.

Q: To what extent do South Africa's problems enter into the relative firmness of the gold price?

A: There's no question that it has some influence on platinum prices. I don't think it has a tremendous influence on gold prices, since there's so much gold around. Coincidental with gold going up, bonds will be going down because they're both responding to the same thing: lack of trust in the American currency, lack of trust in U.S. policies.

Q: This sounds pretty much like a replay of the late 'Seventies.

A: Yeah, it would appear that that's the case.

Q: Do you think that gold has the potential to go to \$800?

A: I don't know levels. We can only look at how cheap gold is.

Q: Is gold as cheap as it was at \$35 an ounce before the breakdown of Bretton Woods?

A: Yes, the way we measure it, and we have a little neat system of measuring it.

Q: What's that?

A: We look at the net external liabilities of the U.S. We divide that by how many ounces of gold the central bank has at Fort Knox, and that gives us some idea of how much gold will have to go up if the U.S. is to remain 100% solvent. In other words, how much the price of gold would have to appreciate so as to enable the U.S. to pay off all of its liabilities in gold. The fascinating thing is that this number, which we've been tracking for the past 15 or 18 years, was rising continuously in the early 'Seventies. It rose above \$35 an ounce while gold was still trading at \$35 an ounce, and it stayed \$20 or \$30 an ounce above market prices continuously until about 1979. In 1979, as the price of gold exploded upwards, our model started to indicate a drop in prices. It went below the gold price, and it led the way down, all the way down. Telling us, in fact, that the U.S. was becoming, in relative terms, a net creditor. And because it was becoming a net creditor, gold was becoming less valuable. This process ended sometime, if I recall, in '83 or '84, when our model indicated a low of around \$240 an ounce. Gold hit a bottom, too, around the same time. And then, this imaginary line began to rise. And it crossed gold prices on the upside, sometime last year.

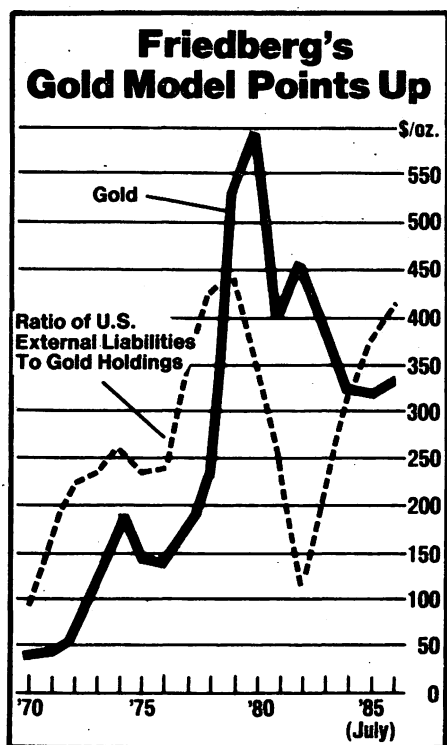
The number has no magic, but it's telling you, from a foreign-exchange point of view, where the U.S. stands today. And those deficits are piling up very quickly. I think that gold will be rising, very much like it did in the late 'Seventies. But I don't know if the rise will carry into other commodities. And I don't think the violence of the inflation will be the same as we had back then.

Q: Why is that?

A: There's a lot more debt today. There's a lot more austerity in business and among individuals. I think that the amount of debt that's in the system today does not allow for unhindered expansion. And so it is possible that supply conditions will remain ample in many commodities for a long time to come.

Q: Higher commodity prices certainly would be a boon to the Canadian economy. To judge by the softness of the Canadian dollar, the economy evidently hasn't been doing too well.

A: More than that, the Canadian stock market has advanced a lot less than the U.S. stock market and, in fact, is one of the world laggards. Can-



ada, of course, is highly dependent on its natural resources. We think that the current-account deficit will be about 10 billion Canadian dollars, which is huge. We think the currency is heading lower.

Q: The change in government didn't help?

A: The conservatives came in and had a very large budget deficit to begin with. They had to eliminate it, but they went about it the wrong way. They started raising taxes. And so you have the situation where the U.S. is lowering taxes and Canada is raising taxes.

And Canada will be hit by a declining trade surplus, by rising taxes and by a weak western economy that is very dependent on timber, on mining and oil and gas.

Q: What about other world stock markets?

A: The German market has come off from its peak quite a bit. The English market has come off quite a bit from its peak. And I think that this is a synchronized drop now. We're entering a bearish phase for all these markets. The last one to hold out is the Japanese market. It's begun to weaken, too.

Q: What's causing this synchronized decline around the world?

A: The drop is due to the recession spreading, and due to the deepening of that recession.

Q: Do you have any stock recommendations?

A: No. We trade the futures. We trade the FTSE in the London market, and the S&P. We're short both of those.

Q: What are some of your other positions?

A: What we call the most exciting currency trade of the year was going short the British pound and going long the German mark or the Swiss franc, on a spread basis.

Q: Is that just another play on falling oil prices?

A: No, it's a combination of many things. It's the fact that sterling is very expensive in real terms. British labor costs have increased phenomenally in the past few years. It's reflected in the fact that their unemployment rate continues to increase every month. It stands now at 13.3%.

Q: Isn't the situation similar in West Germany.

A: Correct. But the English case is even worse. The difference is that the English are now into the fourth year of a recovery. The Germany recovery is not that long. And the English unemployment rate is much higher, increasing by 15,000 a month.

Q: Is that mainly a function of falling oil prices?

A: No. It's a function of very strong unions. Very strong labor monopolies. And a very large increase in labor costs. For instance, inflation in England in the past few years has been running low, 3%, 4%, 5% a year. But their labor costs have been rising at 8% and 9% a year. And so labor, as a commodity, is becoming overpriced. And the inevitable result of overpricing of a commodity is its idleness. Hence you have rising un-

of people are political problems. How do you see that resolved?

A: The unemployment problem, I think, is going to cause a lot of headaches. The British are coming to an election no later than the spring of '88. Margaret Thatcher is not as popular as she was once. The Labor Party has shown a lot of popularity recently. I think Thatcher's going to be facing a very difficult election with unemployment rising, especially if the U.K. economy weakens as we expect it to weaken. The unemployment rate could hit 15%, 16% or 17%. What is she going to do over the short period of time between now and 1988? It's probable that she'll abandon some of her positions. She'll try to either increase government spending or increase accommodation by the Bank of England, to try to lower interest rates and to increase credit.

Q: And to bring about a lower exchange rate for the pound?

A: Exactly. And I believe that it's almost become official policy now to lower the rate of exchange of the pound, which is too high in real terms today because of labor costs and because we have a change in terms of trade. England enjoyed the rise in oil prices from 1977 to the early 'Eighties. And now it's experiencing the pain of declining oil prices. Therefore, the pound is going to have to suffer. Since we published our newsletter about two weeks ago, when we called it the currency trade of the year, it has dropped 5% vs. the Swiss franc and the mark.

Q: While the pound has been hovering around \$1.50.

A: Right. But that's because the other currencies have been very strong against the dollar. The reason why we thought that we should trade this cross rate rather than the pound straight against the dollar, is because we have a lot of doubts about the dollar itself.

We think the dollar is weak, and may get a lot weaker. So rather than short the pound against the dollar, we decided to short the pound against Swiss francs, at a cross rate of 2.73 francs to the pound, and the

pound against the mark, at a cross rate of 3.45. And since then, sterling has declined about 5%. And we expect it to decline another 20%, at least.

Q: Is this a viable strategy for individual speculators?

A: Very much so. We point out that one should do it on an equal dollar basis. So that, in fact, you'd have to juggle a little bit with the contracts. The contracts on the IMM are not all equal in dollar terms. You have 125,000 Deutschmark contracts, which is equal to about

more. But I like to be comfortable with the trade.

Q: Any other positions that you think are especially good?

A: I'm intrigued by the New Zealand dollar.

Q: From the short or the long side?

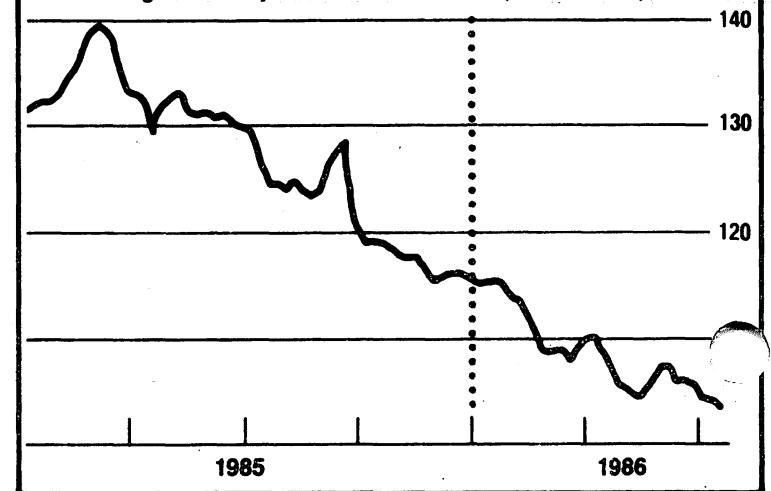
A: From the long side.

Q: Really? What attracts you besides high interest rates?

A: There's a real difference between New Zealand and Australia.

Buck Doesn't Stop Here

Morgan Guaranty Index vs. 15 Currencies (1980-82=100)



\$60,000-odd. The Swiss franc contract—125,000/Swiss franc contract—is equal to about \$70,000. And then you have 25,000/pound-sterling contracts, which is only equal to about \$37,000.

Q: Why long Deutschmark and Swiss franc vs. the pound instead of long the yen vs. the pound?

A: We're a lot more comfortable with the Deutschmark and the Swiss franc. They've gone up a lot less than the yen. They're not as politically motivated as the Japanese yen; they're not as much in the limelight as the Japanese yen. And I think that the Deutschmark and the Swiss franc are cheap in relation to the yen.

Q: How do you come to that conclusion?

A: Knowing how much things would cost in Japan, compared to what they would cost in Switzerland. I'm not sure that Japanese yen won't go up

Q: Being of kiwi descent, I like to hear that. Go on.

A: The New Zealand Labor government that came in in 1984 had a very strong leaning to free markets. The finance minister, a fellow by the name of Roger Douglas, a brilliant man, wrote a book while he was in the opposition in 1980 that was the blueprint for a free market and a turnaround in the New Zealand economy.

And they did a lot of exciting things to liberalize the exchange rate, to liberalize interest rates. They cut back a great deal on subsidies. They opened up the economy to the world by lowering tariffs. They signed an agreement—almost a free-trade agreement—with Australia. They took a number of steps to change that inward orientation. The New Zealand economy has had for almost the past half century.

“There is already substantial cash buying of gold. Which can become a flood, at some point.”

employment. And you've had that for the past few years.

Q: Unlike stocks of corn that can be piled in the silos, excess stocks

Q: Hasn't that really cost them? Aren't they suffering for that now?

A: Yes. There's no question. The transition is expensive. It's expensive in many respects. But they inherited a very high rate of inflation, especially a very high repressed rate of inflation, because the previous conservative government had price controls on for a long time. So they inherited a mess. New Zealand was a country that in the 'Fifties was the third or fourth best in the world, in terms of per capita standard of living. Subsequently, it fell to maybe the 25th or 30th or something like that.

The reform was costly. The adjustment included a recession or a no-growth period. There were a lot of sectors in the economy that were used to subsidies and they were used to an overvalued currency. These sectors are suffering a lot. And on top of that, New Zealand has had the misfortune of being in a difficult trade position. They're dairy exporters and that's not a particularly brilliant commodity to be in these days. But the accomplishments have been many. The rate of inflation is dropping.

Q: To what?

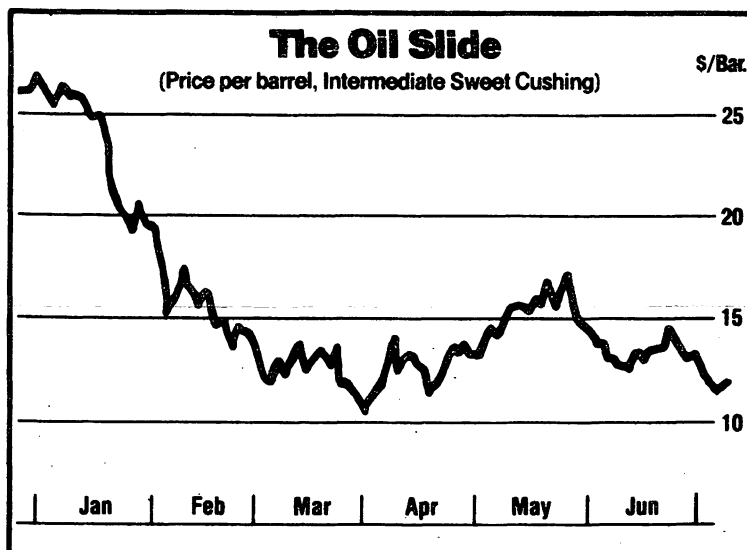
A: It's now around 10%. The introduction of a special value-added tax will increase the rate of inflation for one or two months, but after that we expect

it to decline to maybe 5%. It's coming down rapidly.

Q: And what had it been under the former government?

"We shorted the pound against Swiss francs. Since then, sterling has slid about 5%. Expect another 20% fall, at least."

A: Well, it got to 15% or 16%, but it was repressed, too, in many respects. So it's difficult to tell what exactly it was. Meanwhile, the new government lowered their deficit, by cutting back a lot of subsidies and cutting back a lot of spending. And so their deficit, in relation to the GNP, went from something like 9% to closer to 3%. And it should get smaller. So we think that the kiwi is a very interesting speculation on the long side. You can buy forward kiwis at a very deep discount. Or buy kiwi bonds, issued by multinational corporations, such as Coca Cola, paying 15%-16%—around that—for the next three years. You enjoy a very high rate of interest, and a potential for a turnaround in the currency.



Q: How would the typical investor go about doing that? Have there been New Zealand-dollar-denominated issues in the U.S. market, or just in the Euromarket?

A: There have been issues in the Euromarket—such as Coca-Cola, Honda, Mellon Bank. And then you have Yankee New Zealand-dollar issues sold in the United States. Wells Fargo, Philbro-Saloman and Merrill Lynch have sold them.

Q: What's the exchange rate now?

A: Fifty-two cents.

Q: And you think that's a bottom?

A: We think that it's surely a better buy than the Canadian

dollar. And coming from Canada, I would say it would be better to hold New Zealand dollars paying 16%, than Canadian dollars paying 9%. I think it's better than U.S. dollars paying 7%.

Q: In terms of liquidity, is there enough for more than the two of us?

A: I wouldn't recommend New Zealand dollars to a pension fund that has a billion dollars. But I'd say that for an individual, I think it's a very good buy. Nor would I mortgage my house to buy them, either. I would say that the prudent course to take would be to invest perhaps 20% of my financial assets.

Q: An interesting speculation, in other words. Thanks, Al ■