FRIEDBERG'S
COMMODITY & CURRENCY COMMENTS

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1986: the year of the tiger

There were these two sharp guys grew up in the same neighborhood in Chicago. Their names were Harry and Sam. Harry and Sam liked to play games. Both of them were very competitive. As luck would have it, Harry and Sam always seemed to find themselves rivals — never allies. Stickball, basketball, football, and later cards and pool — they always played against each other. As they grew up, they learned to be enemies.

After they finished school, both Harry and Sam went to the Board of Trade to work. Harry and Sam became commodity traders. They traded sardine futures. For 50 years, they trade sardines. They made fortunes, they lost fortunes, and in the end they both became wealthy men. In all those 50 years Harry never spoke a single word to Sam. And Sam never spoke a word to Harry.

One cold winter's morning Sam woke up and decided he'd had enough. He decided to retire. That entire day Sam was in a reflective mood. Something was bothering him. Something was unresolved. When the bell rang to announce the close of trading that afternoon, Sam walked across the pit to Harry.

"Harry," he said, "we have not spoken to one another for 50 years. And for what? We are both old men now. We won everything we ever wanted to win. Whaddaya say we both sit down for a little bite to eat and bury the hatchet?"

Harry said, "Sam, I agree. And I'm glad you've suggested it. But what should we eat to celebrate the occasion?"

And Sam said, "Harry, we should eat of some of those sardines we played with for 50 years, the ones that made us both wealthy men."

So the two old enemies left the pit and walked side by side into the exchange cafeteria. They sat down at an old rickety wooden table and each of them took out a can of sardines.

Harry opened his can first, stuck his white plastic fork into the thick salty oil, and pulled out a fat greasy sardine.

"Yecch," he said as soon as he had taken a bite." Sam, these sardines are terrible."

Sam looked down at his can of sardines, shrugged his shoulders into a sorry stoop, and said, "Harry, we should have known all along. These sardines are not for eating. They're for trading. We've been playing all these years and you can see — it's a game... only a game."

We've been playing the game, too, for 15 years now, and in 1986, we played it fairly well. As well as Harry and Sam did on average and certainly better than we did in 1985.

If there was a single reason why, it would be because this past year we actually *played* the game rather than — as we have in the past — *theorized* about it. To put it another way, we acknowledged that commodity and currency markets are ultimately moved by men, scared and greedy men, and not simply by our grand theories.

Examples: Rightfully bearish though we were on oil — it did hit, as we predicted as early as two years ago, the previously unthinkable $10/barrel mark — we allowed for short-term adjustments against the downtrend, and traded accordingly. Convinced though we were throughout the year of an imminent burst of renewed inflation, we did not commit ourselves to the short side of bonds without stops. (Remember last year, when, convinced of a depression so severe Freud himself would have been unable to cure it, we sold short the S&P without stops and lost a fortune?)

The only market we remained true to throughout of all 1986 was gold. The inflation we predicted never materialized. Yet, we profited handsomely as gold prices increased by 50%. The rewards we earned for our faithfulness are proof that the occasional dose of naive stubbornness — coupled, of course, with at least a semi-well-devised theory (we did have our model of gold's value as broadly determined by net external US liabilities) — is a necessary part of what it takes to trade successfully.

Harry and Sam ultimately called sardine trading a game. Neither of them said the game was easy.

Following is a brief resumé of the '86 season.

Apocalypse when? We've been known to look not so much beyond the abyss, but *for* the abyss. This year we outdid ourselves predicting: recession, inflation, bond yields rising to

In this issue

Backwardation in the crude oil markets, so we roll short positions to July '87. The fate of the US dollar. Stock index futures: Is this a blow-off? The agricultural crisis, Part I. Contributions by Albert D. Friedberg, Steve H. Hanke, David Rothberg, and Daniel A. Gordon.

paralyzing highs, a stock market panic, the decline of the dollar, etc. And all at once!

The result: The economy continued to grow, wholesale prices fell by 2.5%, interest rates fell, the stock market continued to rise... but yes, the dollar did fall. One for five is not bad. The Blue Jays just agreed to pay a guy who does pretty well the same with the bat a couple of million bucks.

Great party! Too bad there were no guests: the trade-of-the-year-award could have gone to the recommendation to sell short the Oil & Gas Index on the TSE while going long the overall TSE index. Problem was, the market was so small, as soon as one client put on the spread, we owned 100% of the open interest and nobody else could do it. It pays to be the first to arrive; his broker tells us the man made "around a half million or so."

Trade of the year: By October, the stock market sold off sharply. If you called our Hotline number in early November expecting a "we told you so" and thinking "Let those guys tell me whatever they want — every broker's clock will be right twice a day," you could have been shocked by the recommendation to go long the S&P. Long the S&P!! We had been bearish since the Dow was at 780. True to the trend, if not ourselves, we made 1400 points (or $7,000 a contract). A lesson learned? One can only hope.

Solid as a buck: We inveighed, we decried, we admonished, we even devoted an entire newsletter to the premise that it should fall. All to no avail. As intransigent as Ed Broadbent on free trade, the Canadian dollar began the year at .7155 and ended the year at .7243.

Catastrophe of the year: The imposition of draconian foreign exchange controls on the Mexican peso forward market, thus virtually "closing" the market. We were short at 8 pesos to the dollar. We were short at 25 pesos to the dollar. We were short at 100 pesos to the dollar, 150 pesos to the dollar... and we would love to be short today at 950 pesos to the dollar.

Winners: Saudi riyal, the Australian dollar, Mexican peso.

Big winners: Gold, oil.

No brainers: Deutschemark, Swiss franc, Pound sterling, just a joke. But our views on currencies have been so profitable and celebrated — "Al Friedberg... has been dead right in predicting the course of the (US) currency, both in its remarkable rise in the early eighties and its more recent retreat." (*Barron's*, Jan. 19, 1987.)

Losers: Bonds, bonds, bonds, bonds, bonds. (We were stopped out that many times.)

No brains: The stock market. No joke. With the single exception of the trade-of-the-year, our views on equities have been the equivalent of the key to Harry's sardines. Yeech!

Inspired: Jim and Tammy Baker and their late night TV evangelical colleagues may not have been pleased. Nonetheless, our June letter recommending "The short side of the Cross" proved remarkably inspired. Those who sold short the pound while going long the Deutschemark witnessed a somewhat miraculous transmutation of the cross rate to 2.8200 from 3.3700. And a wonderful profit of $16,000 per $7,500 investment.

Amen.

Crude Oil

The backwardation, again

Backwardation in a futures market occurs when nearbys command a premium over deferred contracts. Backwardations are the exception to the rule; contangos — in which deferred contracts trade at a premium (generally equal to carrying charges) over nearbys — are the rule.

Backwardations result, generally, from artificial restrictions on output and/or short-term supply inelasticities. As an example, price controls on copper in the US during the Nixon presidency kept domestic prices below world prices and caused domestic mines and mills to shut down production. As the artificial shortage became aggravated, world prices soared. At this point, spot copper prices went to a premium over deferred contracts, reflecting the desperation of some users for immediate deliveries.

The premium for spot supplies alerted some well inventoried firms to the opportunity of "selling" immediate supplies to the market while buying back these supplies for a later date — a classic lending operation. This extraordinarily clever market mechanism (absolutely not the design of any one guiding hand) succeeded in drawing down every available pound of copper, putting it at the disposition of the immediate user. Backwardations economize supplies when, for whatever reason, the supplies are tight (for a fuller discussion of backwardation, refer to *FC&CC* of Oct. 20, 1985).

The crude oil market's last brush with a backwardation took place in the September 1984 - December 1985 period (Chart 1 reproduced from our November 17, 1985 issue). This period coincided with OPEC's last attempt to hold the $28 price for its marker: Output, which had hovered around 18 million barrels per day (b/d), was lowered to 16.6 million b/d and then to an average of 14.4 million b/d, thanks largely to Saudi Arabia's dogged determination (its own output fell to 2.2 million b/d from 5 million b/d.) Backwardation elicited temporarily unused stocks — the more OPEC cut back supplies, the steeper went the backwardation (the more profitable to "lend" stocks to the market, the less OPEC could sell).

In effect, the backwardation literally forced competing supplies on the market, testing OPEC's resolve and ultimately, as we know, breaking the $28 stranglehold.

Ever since OPEC announced its new production pact (towards the end of December '86), the crude oil futures market moved from a comfortable contango (one that produced immense rollover profits on expiration) to a backwardation (see Chart 2). Admittedly, the sharpness of the current backwardation (5.3% for six months) pales in comparison with the 1985 episode, which reached a high of 13.8% for six months. Nevertheless, there are good reasons for this reduced discount. In the first place, heavy excess production in the third quarter of 1986 has increased stocks by somewhere between 250 and 300 million barrels, a surplus situation that was nonexistent in 1985. Secondly, current production of 16.5-17.5 million b/d is considerably higher then the nadir of 14.4 million b/d reached in the third quarter of 1985. And while worldwide demand *may* have increased some (probably a maximum of 1.5 million b/d), non-OPEC oil production also has increased (particularly in the Soviet Union, which recovered dramatically from the 1985 output slump), leaving OPEC little room to increase output. Finally, the output restriction is only a few weeks old (having started on Jan. 1, 1987, and having accommodated a substantial amount of overproduction in November and December 1986).

Price target tactic dangerous

As of February 1, OPEC intends to move to a price target (see Chart 3), a tactic fraught with danger, given continuously shifting price differentials. In recent days, it has been reported that both Saudi Arabia and Nigeria have been unable to force buyers to contract for five months at fixed scheduled prices. Instead, they have resigned themselves to selling small amounts for February, hoping that market prices overtake their posted prices.

OPEC's discipline will be severely tested in coming weeks. First, the ability of one producer to sell at a posted price will come at the cost of another producer whose differential is misaligned; this will produce tension. Also, refined product sales increasingly are taking the place of crude sales (especially for countries like Kuwait and Venezuela), making it very difficult to detect cheating. At the same time, Iraq, not a signatory to the agreement, will be in a position this summer to move via pipeline an additional 500,000 barrels per day. Finally, and most importantly, unlike 1985, the Saudis are no longer willing to play the role of swing producer; any further cutbacks will have to be shouldered *pro rata* by all the members of the cartel. The probability of this happening is remote.

There remains one (short-term) bullish argument, which runs as follows: Iran captures Basra, Iraq's second largest city, slaughters its inhabitants and further demoralizes the worn out Iraqi forces. President Saddam Hussein is deposed and a Shiite (or Shiite-sympathizer) government is installed in Baghdad. Iran forces on all the (terrorized) Gulf states a reduction of output so as to accommodate higher Iranian output. Simultaneously, it engineers an overall drop in OPEC production.

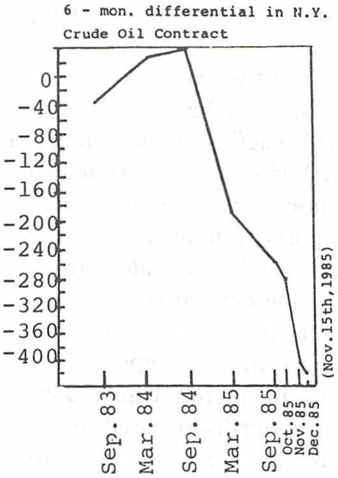
Iran victory not certain

While this scenario is plausible (and we have said so for many months) it is, at best, some time off. With all the fanfare of recent weeks, the Iranians have been able to capture a number of only insignificant and non-strategic islands at a terrible cost of manpower. The approaches to Basra are heavily fortified and defended by the Iraqi Third Army Corps, numbering 50,000 men. They face only 60,000 Iranians, a far smaller ratio than required to gain control of the city. It is rumored that the Iranians will open a new front, north of Basra, in an attempt to cut off Iraqi reinforcements. If so, this maneuver could take the better part of the next two months. In the interim, a failure to capture Basra in this period could force a strategic and partial Iranian retreat and for purely economic reasons: The cost of the war must easily be exceeding oil revenues. Clearly, there is a limit to how much longer the Iranians can feed, clothe, and arm a fighting army of 600,000 to 650,000 men.

We now summarize our views: The oil markets' recent move to a backwardation will make it increasingly difficult for OPEC to sell their projected overall quota. Market forces will mobilize idle surplus stocks, producing great tensions among OPEC producers. As the total pie shrinks, sales of one member will come at the expense of another one. The lack of a swing producer, sensitive to any slight indication of excess production, will contribute to overall surplus production, which, in turn, will pressure prices and intensify a beggar-thy-neighbor policy. No later than March/April, the $18 agreement will come apart.

STRATEGY: *We have advised (see Hotline update) rolling nearby short positions to July '87, waiting for the backwardation to steepen somewhat and do "its job." Furthermore, should Basra fall, it will allow us temporarily to hedge the short positions via long nearby contracts.*

Chart 1



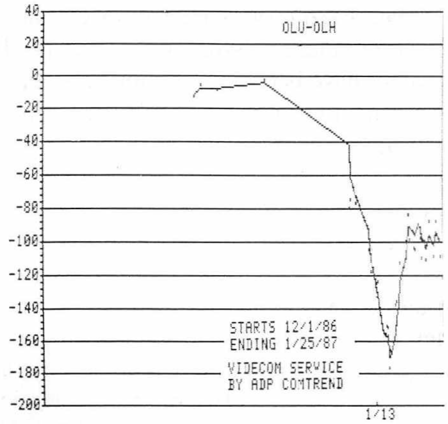


Chart 2

OPEC Prices

New prices to be charged for various OPEC crudes starting Feb. 1

CRUDE	PRICE PER BARREL
Sahara Blend	$18.87
Minas	17.56
Bonny Light	18.92
Arab Light	17.52
Tia Juana Light	17.62
Zaraitine	18.87
Oriente	17.02
Mandji	17.32
Kuwait Export	16.67
Brega	18.67
Zueitina	18.67
Dukhan	17.82
Marine	17.67
Murban	17.92
Zakum	17.82
Umm Shaif	17.72
Tia Juana Medium	16.72
Arab Medium	16.92
Arab Heavy	16.27
Arab Berri	17.87
Iran Light	17.50
Iran Heavy	16.89

Chart 3

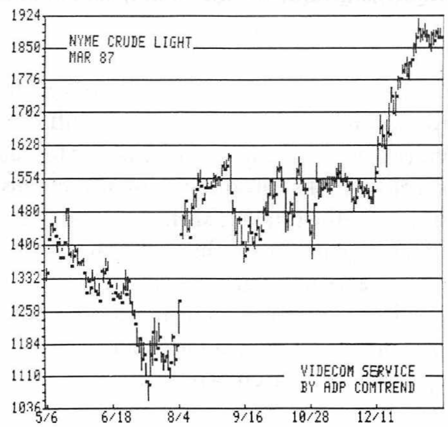


Chart 4

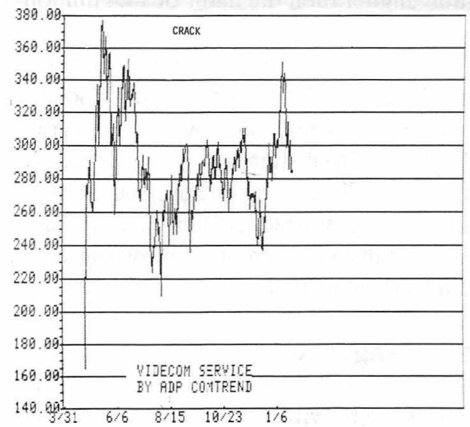


Chart 5

Soft dollar, hard landing

As the dollar continues to be clobbered, it is becoming clear that if we aren't already in one, we are perilously close to a full-blown currency crisis. In consequence, a soft dollar might well experience a hard landing.

The problem. The current account, which is part of the balance of payments statement, is equal to the sum of the balances on the merchandise, services, and unilateral transfer accounts. Among other things, the balance on the current account indicates whether a country is a net borrower from, or lender to, the rest of the world. For example, a current account surplus implies that a country is a net lender to the rest of the World; a deficit implies that it is a net borrower.

During the 1960s, the US recorded an accumulated surplus of $33 billion on its current account. The amount received from exports of merchandise and services exceeded the sum of imports and net unilateral transfers. The accumulated surplus on the current account during the 1960s was offset — so that the basic balance on the balance of payments balanced — by an outflow of capital to foreigners.

In the 1970s, the picture began to change: The surplus on the current account disappeared, and a cumulative deficit of $5 billion was recorded. In the 1980s, the current account deficit has soared. For the five years ending 1986, the cumulative deficit exceeded $410 billion, with about $140 billion of the total being recorded in 1986. This deficit has been offset by massive capital inflows from pools of foreign savings. The upshot of the US's spending and foreign borrowing spree is that the nation has become the world's largest debtor.

That the US's mounting external debt is a problem of the first order — one that might lead to a hard landing for the dollar — is a view that most foreign economists and an increasing number of foreign investors share with us. However, as Professor Masahiro Kawai, an international finance expert at the University of Tokyo, put it to us earlier this month: What's surprising and somewhat alarming is the fact that "US scholars and economists are generally insensitive to the US's mounting external debt."

The absorption framework. To analyze the problem facing the US, we employ the absorption framework. This framework focuses on how domestic spending on domestic goods changes relative to domestic output. With the absorption framework, the balance of trade is viewed as a residual given by the differences between what the economy produces and what it takes for domestic use, or "absorbs." Absorption represents total domestic spending (the sum of consumption, investment, and government spending), so that if absorption exceeds domestic production, then the excess domestic demand is met through imports. This, of course, represents the current situation in the US, where the trade balance is in deficit.

Expenditure-switching. One classical solution for the situation in which absorption exceeds domestic production is to employ expenditure-switching policies. Two types of expenditure-switching policies can be distinguished. One is devaluation. By making a country's goods relatively cheaper compared with foreign goods, devaluation will tend to switch both domestic and foreign expenditure towards domestically-produced goods.

In the US, a devaluation policy has been pursued with vigor. However, to date, it has not met with much success in stimulating expenditure-switching. One reason for this is a fact that we have mentioned repeatedly: The real value of the dollar has not yet depreciated dramatically, when measured against the broad spectrum of the US's most important trading partners' currencies. If this weren't enough, the depreciation that has occurred in the dollar's value hasn't been fully passed through to import prices because foreign exporters have absorbed a great deal of the dollar's fall by reducing their profit margins. In consequence, the pass-through of the dollar's decline to increases in import prices has been modest.

The second expenditure-switching policy involves the application of controls. These include policies designed to reduce or block imports, as well as those intended to stimulate exports. Each attempts to switch expenditures away from foreign output toward domestic output.

In addition to devaluation, the US has leaned heavily on a wide range of expenditure-switching controls. Moreover, if one gauges from the rhetoric in Washington, D.C., there will be an additional application of controls in the coming year. Even though the trade deficit is large and doesn't appear to be closing, we should mention that controls have induced some expenditure-switching. In consequence, the deficit would be larger if there were no controls. For example, we estimate that about $51 billion, or 14%, of total US imports in 1985 were covered by high tariffs, quotas, or voluntary restraint agreements. (We should also mention that the relative "effectiveness" of controls doesn't imply that we believe they are desirable.)

Expenditure reduction. The second classical solution for excessive absorption is a reduction in aggregate domestic expenditures. This can be accomplished through tightened fiscal and/or monetary policies. These policies act to reduce absorption directly.

While the US has pursued policies aimed at switching domestic and foreign expenditure away from foreign towards domestic goods, it hasn't implemented expenditure-reducing measures. In fact, it has followed a contrary course. Federal budget deficits have run up a string of records, and monetary policy has become increasingly loose, when measured by the growth in the monetary base, or the Ms. In consequence of the US's expenditure-increasing, rather than expenditure-reducing, policies, excessive absorption continues to be a problem, with no adjustment in sight. That is to say, we don't anticipate much in the way of federal deficit reduction. Moreover, the Federal Reserve Bank appears to be, for the time being, rather unconcerned about the exploding monetary base and Ms. This, of course, could change if the Fed's targets begin to move, but not before. That is, the Fed would probably tighten monetary policy, if the dollar continues to fall and, at the same time, commodity prices begin to rise and the yield curve becomes steeper.

Hard landing. Armed with rather ineffective expenditure-switching policies and a perverse set of "expenditure-reducing" policies, it appears that excessive absorption will continue to be a serious problem and the trade gap will remain unrelenting. At this point, we must mention that Treasury Secretary James Baker's insistence that our trading partners (primarily West Germany and Japan) adopt policies to stimulate their economies would, if followed, give the US some relief. However, Mr. Baker's proposal would not solve the US's problem because the income elasticity of demand for US imports is significantly higher than that for its exports. In consequence, even if the US's trading partners' growth rates increased to match that of the US, the US would probably face a secular deterioration in its trade balance. Or, to put it another way, Mr. Baker's policy, if it were to bear real fruit, would require Japan — a country in which income elasticities for its exports are substantially higher than for those for its imports — to grow perhaps four times faster than the US. Japan, of course, doesn't appear on the verge of adopting policies that would generate this result.

It appears more and more likely that at some point, foreign investors will realize that the US cannot continue to pile-up large current account deficits and finance them with foreign borrowing. If this point is reached, foreigners will withdraw funds from the US. Such a move would simultaneously cause US interest rates to surge upward and the dollar to fall to a hard landing vis-à-vis the yen and the major European currencies. In consequence, a major recession would develop in the US, and it would be transmitted to Japan and Europe.

STRATEGY: *Retain long positions in Swiss francs and DM. Raise stops to 64.25 and 54.10 respectively, close only. Remain firmly long gold.*

Short positions in US T-bondss were stopped out at 100.31, as per last month's advice; reinstate short positions and place new stops at 102.05, basis March '87, close only. Remain short March '87 and June '87 Eurodollars, risking 94.25, close only.

A noteworthy observation: The yield curve is likely to widen in weeks ahead for four reasons: inflationary expectations (see CRB index, poised for a new recovery high, Chart 6); foreigners' concerns about the dollar and the US external debt will cause them to moderate their demand for bonds; heavy purchases of T-bills by foreign central banks flooded with dollars; and nervousness on the part of the Fed with LDC debtors. In the end, however, a plunging US dollar will cause the Fed to raise, somewhat reluctantly, short-term rates. Then, the yield curve will narrow.

— Steve H. Hanke

Chart 6

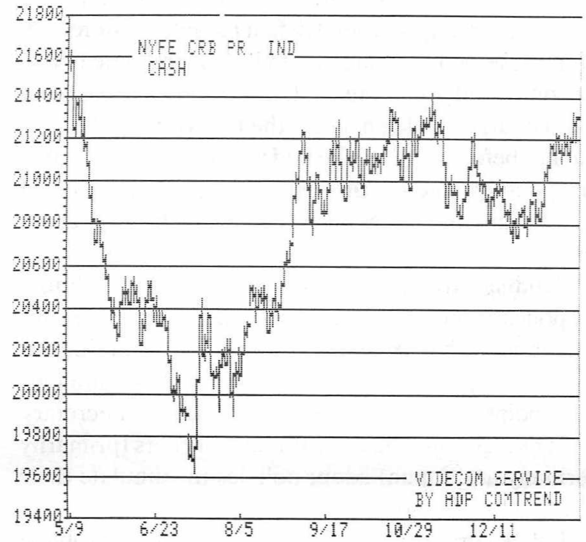


Chart 7

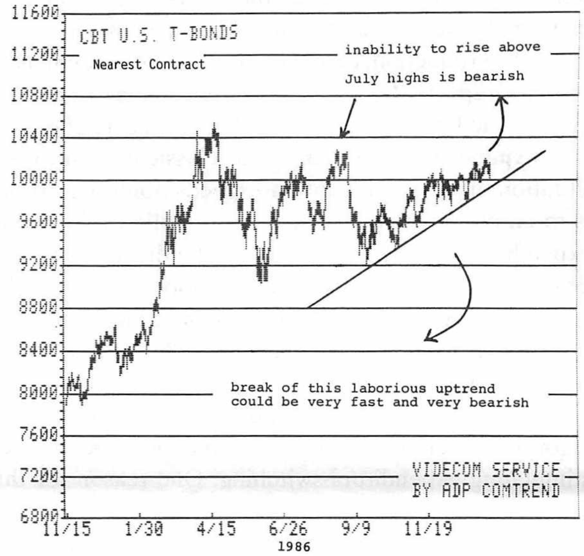


Chart 8

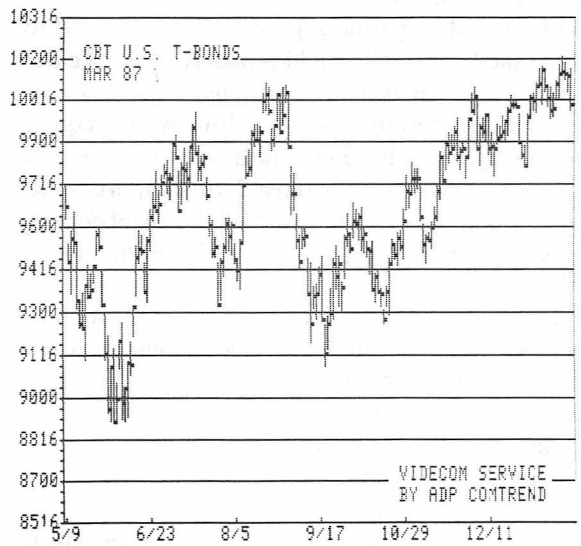


Chart 9

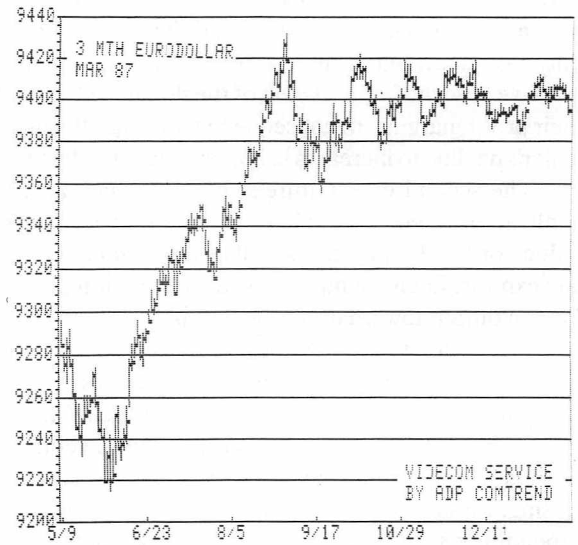


Chart 10

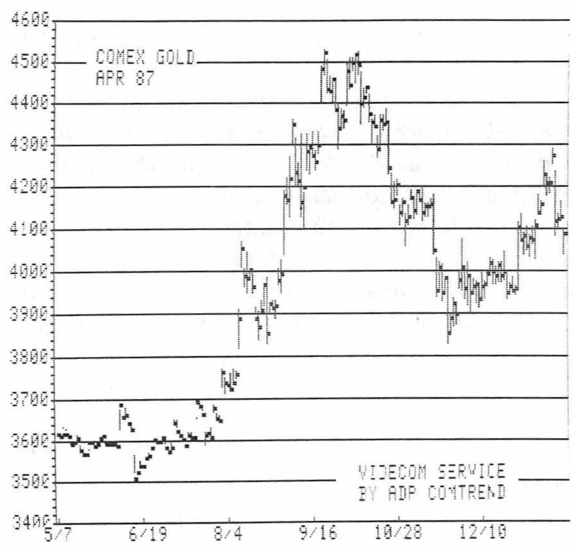


Chart 11

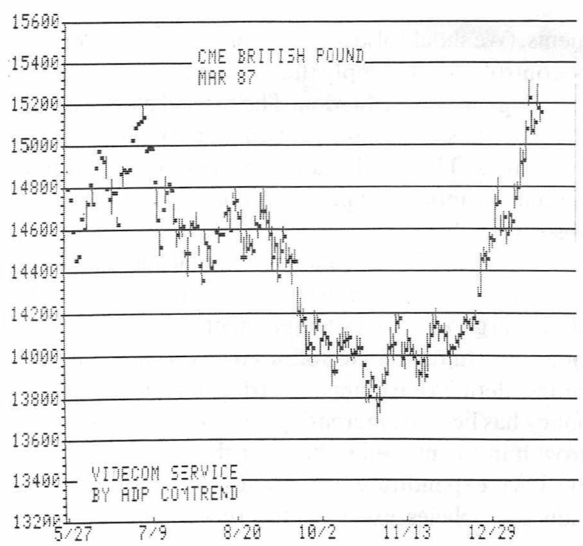


Chart 12

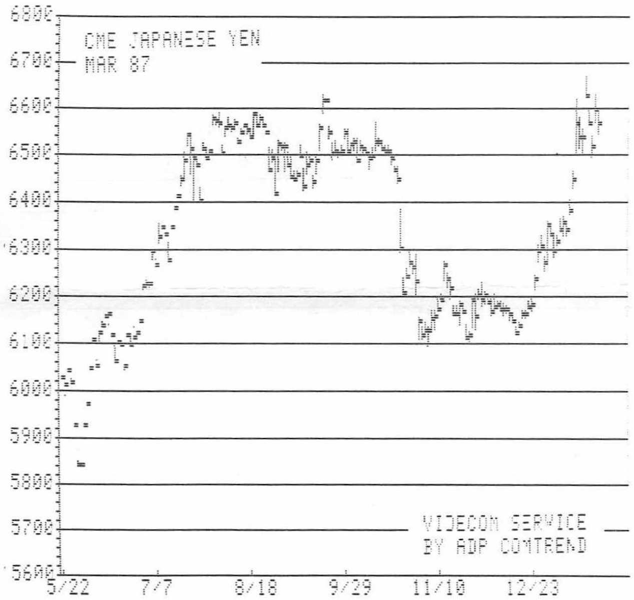


Chart 13

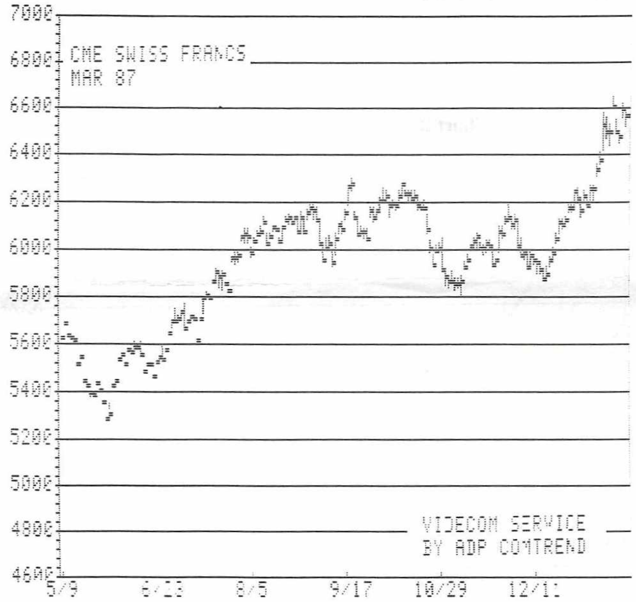


Chart 14

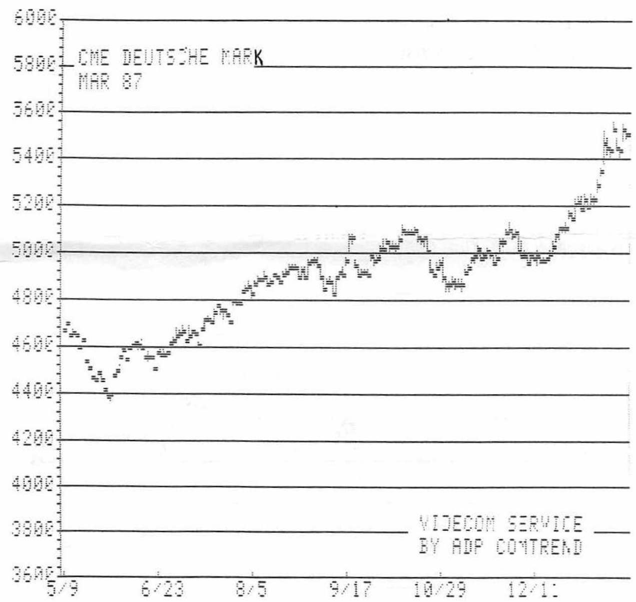
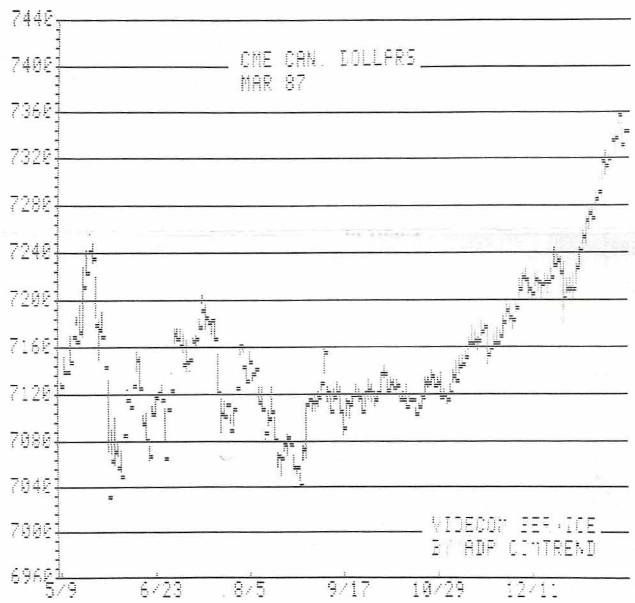


Chart 15



Sterling Financial Instruments

1) Stopped out of the March '87 FTSE 100 at 170. Last trade 182.00 (see Chart 16). Await further developments.
2) Remain short March '87 LIFFE short Sterling deposit (Chart 17), placing stops at 89.65, close only.
3) Remain short March '87 LIFFE long gilt (see Chart 18), placing stops at 118½, close only.

Chart 16

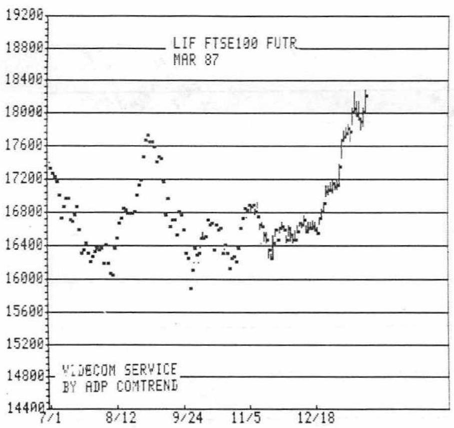


Chart 17

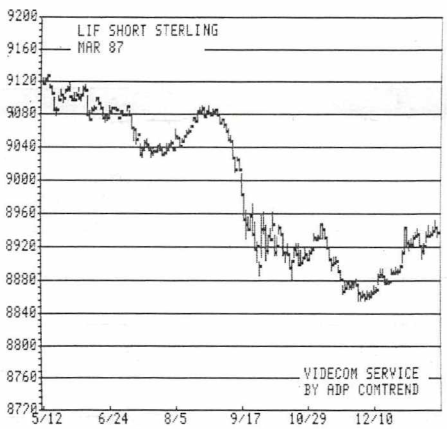
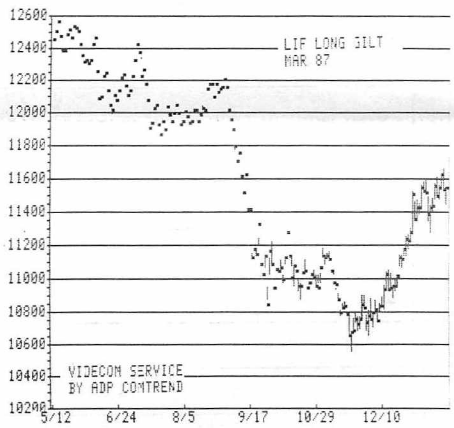


Chart 18



Silver and Platinum

***STRATEGY:** Retain long positions in April '87 platinum and March '87 silver as suggested in last month's* FC&CC. *Raise stops to 480 and 5.39 respectively, close only.*

Chart 19

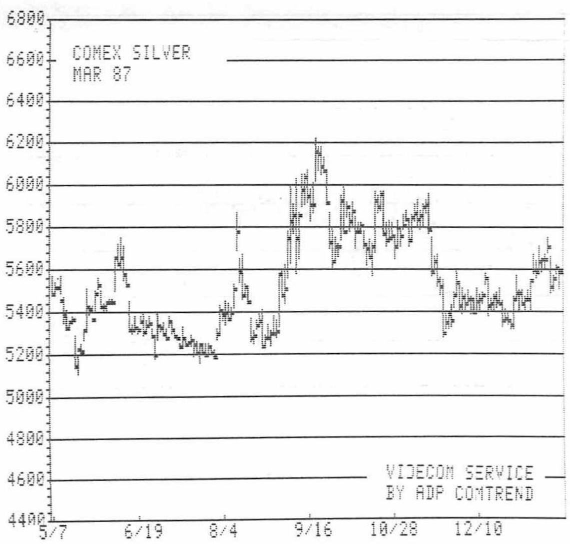
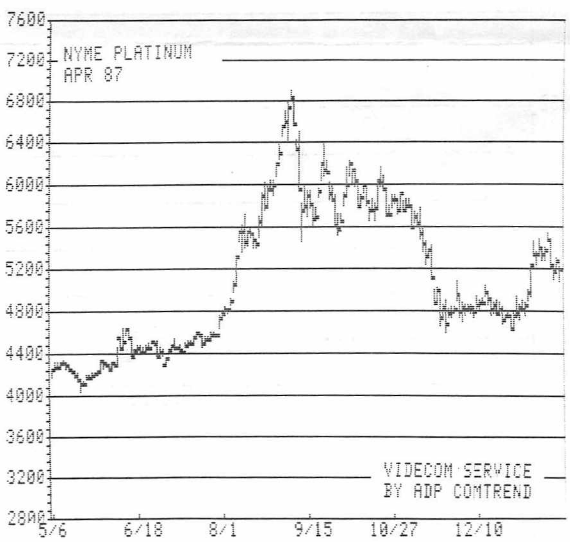


Chart 20



Stock Index Futures

In what may be a series of climatic reversals leading to a final top, the stock market stunned the financial world by plunging a record 115 Dow Jones points (5.2%) in 71 minutes after having reached a new all-time high of 2210. In spite of the violence of the move, it is unlikely that we witnessed the final reversal for the following reasons: (1) it was the *first* high-volume reversal — reversals usually are preceeded by two, three, or more attempts; (2) even as the fall was terrifying in speed and magnitude, it failed to trade and close below the previous day's low; and (3) the principal indexes missed recording weekly reversals (not so the Value Line Index, which did), and the same was true for some of the leading shares, i.e., Ford, Exxon, American Express, General Electric, and so on.

Why are we so sure that we have entered the "blow-off" stage? For one thing, p-e ratios and dividend yields are reaching extreme readings. For another, it is unlikely that monetary policy (which has clearly caused this explosion in financial instruments) will continue as easy as it has been to date (a 32.2% annual rate of expansion in M1 over the past eight weeks!), considering the collapsing US dollar. Also, breadth continues to lag badly, with the S&P 500/Value Line spread widening to 2700 points. Finally, sentiment has turned euphoric, with nary a long-term bear in sight.

How high will this market go? Blow-offs are totally unpredictable as to extent. How much longer will it run?

Blow-offs rarely last longer than 60-75 days, suggesting a final top somewhere in late February-early March (see Charts 23, 24 and 25 for some unused blow-off specimens). Will the top ring a bell? It might — a sure sign will be a climactic, high-volume *weekly reversal.*

STRATEGY: *Stand aside. A once-in-a-generation short selling opportunity should present itself very shortly. Keep posted.*

Chart 21

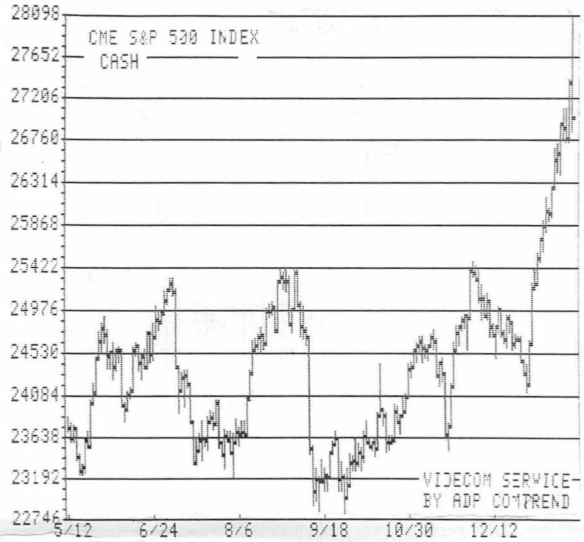
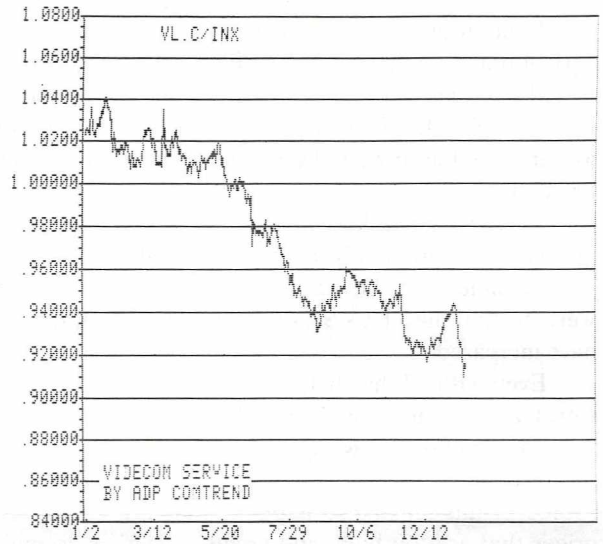


Chart 22



Agriculture in crisis: Part I

That international agriculture is in a state of crisis won't come as news to anyone. What's of interest here isn't the crisis *per se*, rather it is the prospect for change.

Crises usually contain the seeds of change because most people aren't attracted by suicide. We offer a two-part series on agriculture in an attempt to see what policy changes are in the winds, how they might affect trends in various markets, and what trading opportunities might develop. Our first installment is intended to set the stage for the analysis, which will follow in Part II.

Our stage-setting task has benefited greatly from the works of Mr. Geoff Miller, Secretary of Australia's Department of Primary Industry. In particular, we focus on the findings contained in his most recent book, *The Political Economy of International Agricultural Reform*, which was published in 1986.

The crisis. A glance at prices and stocks reveals a great deal about the crisis. During the 1980s, wheat prices have plunged 45%, while world stocks have risen 69%. This pattern has been mirrored by rice and feed grains. Grain stocks in the US alone equal about two years' total world trade. Sugar stocks are up 45% since 1980 and prices are about 86% below 1980 levels. World butter stocks have ballooned by almost seven times their 1980 levels and prices have fallen by 50%. The stocks of beef are way up, with the EC's alone equal to about 30% of annual world beef trade. Cotton stocks have more than doubled in this decade, and we could go on.

While prices were collapsing and stocks soaring, the costs of farm programs were skyrocketing. In the US, what were \$3-\$5 billion in annual taxpayer subsidies in the early 1980s are now \$30 billion (15% of the federal budget deficit). This subsidy amounts to almost \$700 for each non-farm family in the US. Consumers in the US are paying another \$6 billion annually because prices for products like sugar and dairy goods are administered above world prices. The EC's Common Agricultural Policy is also faced with a runaway budget. Despite increases in agriculture's share of the EC's value added tax, the agricultural program's expenditures are running well above its income, and unless something is changed, the program faces certain bankruptcy. At present, EC farm subsidies are costing each European non-farm family \$900 annually. In Japan, farm programs are running about \$15 billion annually, and Japanese consumers are paying prices that are at least 60% higher than world prices.

In addition to the massive taxpayer-consumer costs of agricultural programs, agricultural policies have adversely affected national income growth and domestic employment. For example, the EC estimates that it has lost one million jobs in manufacturing and services as a result of agricultural protection.

These programs have also adversely affected world trade and incomes, particularly the less developed countries (LDCs). For example, in 1983, US and the EC sugar policies alone were costing the LDCs \$7.4 billion. Since then, these costs have increased.

Even with all the "help," many farmers throughout the world face serious financial problems.

Source of the crisis. Agricultural supply is currently outpacing demand, even at existing depressed world prices. The source of this imbalance is public policies that administer prices that are too high, and create incentives to maintain and/or even expand world output. These administered prices can be kept too high by a set of protective tariffs and quotas. Grain, sugar, dairy products, and beef are products that typically have their prices administered and protected, so that internal prices are often many times higher than world prices.

The disequilibrium between internal and world prices is called the price adjustment gap. This gap can be measured by the ratio of internal support prices to world prices. A ratio of one indicates that internal and world prices are equal. A few adjustment gap ratios will give one a feel for the magnitude of disequilibrium: for rice, the gap ratio in Japan is almost 8.5; for wheat, it is about 2.0 in the EC and 1.5 in the US; for sugar, it is 14 in Japan and about 3 in both the US and the EC; for butter, it is 7.75, 2.9, and 2.75 in Japan, the US and the EC, respectively; and for beef, it is 2.5 in both Japan and the EC, and 1.25 in the US. These ratios have generally increased since 1980.

It is important to stress that the price gap overstates the magnitude of the disequilibrium. If the incentive to produce were reduced, world prices would rise, at least after an initial adjustment period.

Reform. To lift agriculture from its current crisis, reforms must aim at closing price adjustment gaps. This might be easier said than done because any reform must address three immediate problems: (1) the disposition of the massive stocks of farm products; (2) the fact that early in any reform, the level of supply will continue to exceed demand, maintaining downward pressure on prices; and (3) incomes of farmers will fall early in any program that reduces support prices.

In the next installment, we explore some proposals to close the price adjustment gaps and what they might hold in the way of future trading opportunities.

— Steve H. Hanke

Chart 23

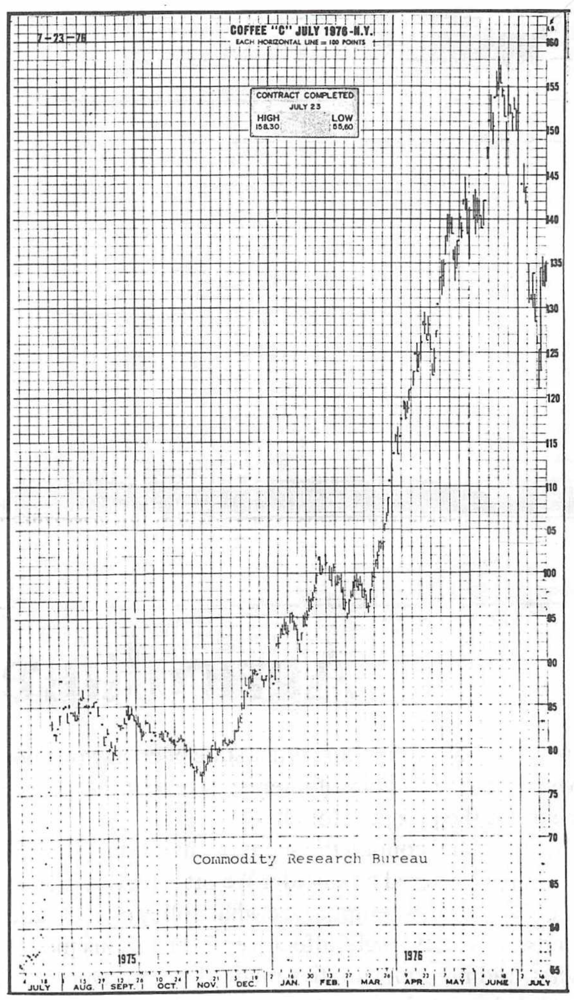


Chart 25

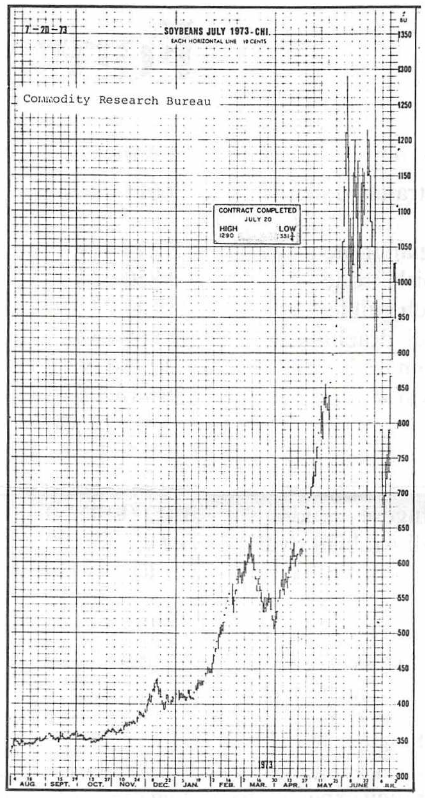
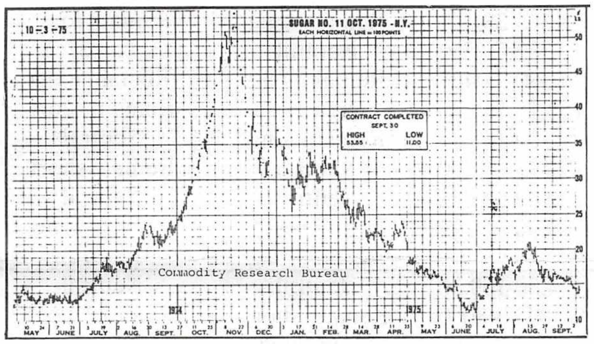


Chart 24



Friedberg Capital Markets

Foreign currency bonds and your RRSP

The 1986 RRSP deadline is little more than a month away (March 2). Now's the time to fill that hole in your self-directed RRSP with high-yielding bonds issued by foreign governments and blue-chip corporations. One look at Chart 26 will convince you of the superb opportunity these investments could present for your RRSP. Call Friedberg Capital Markets today for the bottom line on foreign currency bonds.

Chart 26

DATE: January 23, 1987

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

ISSUER MTY. DATE/COUPON	BID	OFFER	CURRENT ANNUAL YIELD TO. MTY.	CURRENT COUPON PERIOD
NEW ZEALAND DOLLAR DENOMINATED BONDS				
COCA COLA FIN. Corp. 16/6/89 18%	102 3/8	- 103 1/8	16.14	16/6/86-16/6/87
HONDA Int'l 20/9/89 16 3/8%	99½	- 100¼	16.11	20/6/86-20/9/87
HONDA Int'l 28/5/90 16%	98 3/4	- 99½	15.93	28/11/86-28/5/88
TOURIST HOTEL CORP.(N.Z.) 4/6/93 zero coupon	40¼	- 41	15.08	matures 4/6/93
BANK OF NOVA SCOTIA 15/9/89 18½% **RRSP eligible**	104 1/8	- 104 7/8	15.93	15/5/86-15/9/87
WELLS FARGO 12/5/89 16 1/8%	98 1/8	- 98 7/8	17.39	12/11/86-12/5/87
DEUTSCHE MARK DENOMINATED BONDS				
REPUBLIC OF PORTUGAL 19/6/94 6 5/8%	101	- 101 3/4	6.31	19/6/86-19/6/87
GOVT.OF BELGIUM 29/4/96 5½%	94½	- 95¼	6.19	29/4/86-29/4/87
QUEBEC HYDRO 1/5/96 5½% **RRSP eligible**	96½	- 97¼	5.88	1/5/86-1/5/87
SWISS FRANC DENOMINATED BONDS				
GOVT. OF AUSTRALIA 30/10/98 5%	102½	- 103¼	4.63	30/10/86-30/10/87
JAPANESE YEN DENOMINATED BONDS				
GOVT. OF CANADA **RRSP eligible** 23/7/93 5 5/8%	102	- 102 3/4	5.11	23/7/86-23/7/87
U.S. DOLLAR DENOMINATED BONDS				
CHRYSLER FIN. CORP. 1.8/94 9.3% (pays quarterly)	103	- 103½	8.95	1/11/86-1/2/87

U.S. DOLLAR DENOMINATED FLOATING RATE NOTES

ISSUER	MAT.		BID	OFFER	CURRENT COUPON	NEXT COUPON DATE
SANTA BARBARA SAVINGS & LOAN (fully collateralized)	18/12/95	pays 1/8% over 3 months LIBOR (quarterly)	99.39-	99.69	6½%	18/3/87
LINFIN SAVINGS & LOAN (fully collateralized)	14/11/95	pays 1/8% over 3 months LIBOR (quarterly)	99.35-	99.65	6¼%	17/2/87
WELLS FARGO	3/4/2000	pays 1/8% over 1 month LIBOR (monthly)	99.28-	99.58	6 3/8%	20/2/87

****

For further information current prices please call: FRIEDBERG CAPITAL MARKETS
(416) 364-2700

Forex Rates & Update

Currency	*Spot*	*3-Month*	*12-Month*	*Comments vis à vis US$*	*Comments vis à vis DM (Spot DM 1.8200)*
*Australian dollar	.6615-.6620	.6451-.6460	.6060-.6075	Liquidated (see Update)	Liquidated (see Update)
Belgian franc	37.75-37.80	37.94-38.03	38.25-38.45	Remain long	Remain long
*Danish krone	6.8850-6.8900	6.9480-6.9620	7.1300-7.1550	Neutral	Cover
Dutch guilder	2.0540-2.0550	2.0506-2.0521	2.0380-2.0405	Remain long	Remain long
Greek drachma	132.65-132.75	138.45-140.25	153.15-162.25	Neutral	Remain short
Italian lira	1295-1296	1297-1298	1300-1302	Remain long	Neutral
Kuwaiti dinar	.28140-.28190	.28155-.28240	.28215-.28400	Neutral	Remain short
Malaysian ringgit	2.5500-2.5530	2.5510-2.5570	2.5600-2.5830	Neutral	Neutral
New Zealand dollar	.5380-.5390	.5160-.5180	.4700-.4750	Remain long	Remain long
Norwegian krone	7.0550-7.0600	7.2250-7.2370	7.7250-7.7400	Remain long	Neutral
Portugese escudo	141.00-141.50	144.50-146.50	149.90-159.50	Neutral	Neutral
Saudi Arabian riyal	3.7495-3.7500	3.7575-3.7600	3.7895-3.8000	Remain short	Remain short
*Singapore dollar	2.1400-2.1430	2.1281-2.1318	2.0975-2.1105	Liquidated (per stop	Liquidated (per stop)
Spanish peseta	128.75-128.85	130.65-130.95	135.45-136.25	Neutral	Neutral
Swedish krona	6.5050-6.5100	6.5625-6.5735	6.7490-6.7640	Remain long	Neutral
Venezuelan bolivar	22.90-23.00	23.65-24.25	26.40-28.00	Neutral	Neutral

Explanatory Notes

*Indicates change in recommendation from last issue

	US$	DM
Currency expected to firm against both currencies.	Buy	Buy
Currency expected to strengthen against US $ and weaken against DM.	Buy	Sell
Currency expected to weaken against both major currencies.	Sell	Sell
Currency expected to weaken against US $, but strengthen against DM.	Sell	Buy
Term used to liquidate short position but does not imply a new buy recommendation	Cover	
Term used to indicate sale advice of previous long position, but does not imply a new short sale recommendation.	Liquidate	

Hotline Update

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

Friday, Dec. 19: No new changes or new recommendations.

Tuesday, Dec. 23: No new changes or new recommendations. Next regular update Dec. 30, due to holidays.

Tuesday, Dec. 30: No changes or new recommendations. Next regular update Friday, Jan. 2.

Tuesday, Jan. 6: Due to the holidays, we did not put on a tape last Friday, Jan. 2. We have just one recommendation: Switch short positions in February crude oil to March '87.

Friday, Jan. 9: Recap of the week's recommendations:
1. You rolled over your February crude oil position into March.
2. Based on our last market letter recommendation, you are stopped out of your short T-bond position as of Wednesday's close of 101.00.

Tuesday, Jan. 13: Last Tuesday, Jan. 6, we recommended short February crude oil positions be rolled over to March. We *now* advise to roll over all short crude oil positions further out to preferably July. We expect the backwardation to widen further before the heat on OPEC becomes unbearable. Our next newsletter will comment on this phenomenon.

Friday, Jan. 16: A recap:
1. We have rolled over all short crude oil positions to more deferred months, preferably July. We expect the backwardation to widen further.
2. One new recommendation: Liquidate all long Australian dollar positions accepting sizable profits.

Tuesday, Jan. 20: No new changes or new recommendations.

Friday, Jan. 23: No changes or new recommendations.

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