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COMMODITY & CURRENCY COMMENTS

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Bubble, bubble, toil and trouble...

A financial mania has gripped the world. Stock markets from around the globe have been rising relentlessly in spite of, at best, lukewarm fundamentals.

Rising in the face of adversity is not a strange phenomenon. In fact, a true and well tested adage has been coined about bull markets: They climb a wall of worry. As a recession's trough is past, share prices begin to rise; while the contemporaneous evidence is bleak, markets anticipate rising earnings and dividends. Thus it is not surprising that grotesque price-earnings ratios, some even bordering on infinity, make their appearance in the earliest phases of a bull market. As the economic recovery proceeds, earnings come into focus. A rough form of arbitrage begins to take place between money market rates and share prices. After all, the end all and be all of investments *is* return.

Once upon a time, dividend yields and bond yields were compared. Admittedly, business cycles and the vicissitudes of entrepreneurial life made dividend payments *riskier* than bond yields. At the same time, however, dividend payments tended to rise over time as companies participated in the secular growth of the economy's nominal income, while of course, bond coupons were fixed until maturity. Rational investors would thus "arbitrage" the two markets: If dividend yields were higher than bond yields (as for instance in the late '40s and '50s in the US), stocks were cheap and held out further promise of capital appreciation. In the event that bond yields exceeded dividend yields, share prices were "pricy": An adjusting decline was in order. Towards the late '20s, a significant overvaluation of stocks occurred as their dividend yields fell well below long-term bond yields. This over-valuation warning served well the few rational investors of the day.

With time and as memories of the depression faded, the rational investor "rationalized" a new yardstick: earnings yield (the reciprocal of p-e ratios) were as important, if not more so, as dividend yields. It was not without some logic. Retained earnings, ploughed back in the corporation, will at some future time augment dividend yields significantly just as they are increasing book values. What difference did it make to the investor if he received his return by way of a cash payment or instead by way of increased equity (with increased dividend potential)? In fact, the more lenient capital gains tax made capital appreciation a more important component

of financial return than cash dividends. The stage was set for a new comparison: Earnings yields versus bond yields. In all fairness, this new formula was forced upon the bulls in the late '50s after rising stock prices made dividend yields fall below bond yields. The new era bull market needed a new rationale — and it got one.

Earnings *measurements* were not as conclusive as dividend *payments*; they were more open to manipulation. Dividends, instead, were paid if they were truly *earned*. Earnings were announced even if they were not. Be that as it may, logic once again argued that earnings yields should be roughly comparable to bond yields: on the one hand, growth made them *more* desirable; on the other hand, greater relative risks made them *less* desirable. A reasonably rational investor would arbitrage them, assuming a par return.

In 1961, just at a time when government bonds yielded 4%, p-e ratios peaked at 22.9x (a 4.3% earnings yield). Reasonably close. The bull market lasted a few more years, peaking in early 1966 at an approximate p-e ratio of 20x (a 5% earnings yields). By then, of course, Vietnam and inflation had conspired to take bond yields up to 4.5%. Again, stock and bond prices were "reasonably" aligned.

The 1973 bull market peak saw a much lower p-e ratio of 14x (7.1% earnings yield). By then, of course, bond yields had risen to 6.5%.

Our account now takes us to the mid-'80s and in particular March 1987. Long-term government-bond yields are around 7.75% (that is the rate for a *riskless* investment; long-term blue chip A-AAA corporates yield in the vicinity of 8.5%). Clearly, earnings yields should not deviate greatly from 7.75%. But that means that p-e ratios should not exceed 12.9x! Why then is the S&P 500 trading at 19.7x earnings and the Dow Jones at 20.2x earnings? Have historical valuation guidelines been thrown out the window? What *is* the rationale for such a gap?

In this issue

Crude oil: long- and short-term both point down. Inflation on the march... followed by interest rates and gold. And the US dollar comes under pressure... again. Contributions by Albert D. Friedberg, Steve H. Hanke, Daniel A. Gordon, and Michael D. Hart.

Do markets believe that: 1) Earnings growth will exceed the long-term historic norm in the period ahead, despite good evidence to the contrary in recent years? 2) There is no longer a business cycle or even a *business* risk for today's leaders of industry?

Rational investors could not possibly believe that the present divergence is justifiable. So then what? They are caught in a financial bubble, in much the same way inflation hedgers paid \$850/oz. gold in 1980, the nifty-fifty commanded average multiples of 50x earnings in 1973, farm prices were bid up to 1% yields in the late '70s, thousands of dollars were paid for rare and common tulip bulbs in seventeenth century Holland and so on. Ironically, the overvaluation of the '20s seems quite mild in comparison with today's. After all, bond yields of 3.6% then justified a multiple of 27.8x.

In Britain, bond yields justify a multiple of 9, but p-e ratios stand at 17.2x. The most dramatic example of insanity is Japan where corporate bonds yield around 5%, justifying a p-e ratio of 20x. The Nikkei averages trade at a multiple in excess of 54x! To top it off, the recently privatized Nippon Telephone and Telegraph trades at 234 times earnings!

We return to our opening paragraph. Rising in the face of adversity is a classic stock market phenomenon, nearly always appearing in the early stages of a bull market when earnings have, as yet, not recovered from the recession. Four years after the trough of a recession, as now, earnings have already advanced significantly and are probably close to a *cyclical peak*. They must bear some relationship to competing financial returns such as long-term bond yields. Some overvaluation of stock prices is nearly always present at the top of a bull market. But a 50% overvaluation is a sign of irrationality — even madness. And when the phenomenon is worldwide, then we are in the midst of a financial bubble.

It cannot end well. The wealth losses in realignment will be staggering — their impact on consumption and, more, particularly, investments will be devastating. Equity values world-

wide have *increased*, in the past few years, by more than \$5 trillion. When they begin to slide, governments will be unable to halt the slide. The immensely wealthy Kuwaiti government found this out, at great cost, after *their* financial bubble burst in the early '80s.

How does it end? Mostly it just ends — with no specific reason to account for the break: Witness the unexplainable waves of selling that occurred in the September-October 1929 period. Technically, distribution (the movement of stock from strong to weak hands) is complete and the market falls, first on profit-taking and then in panic. The news, the events, follow the break and in retrospect make the crash more understandable.

In March 1987 we *know* that the following will most certainly happen: Inflation will return (see following article), and the dollar will weaken again because domestic spending is still excessive and the current account deficit will widen. The result is that the Fed will sooner or later have to tighten. Excess liquidity will evaporate. Liquidation will follow.

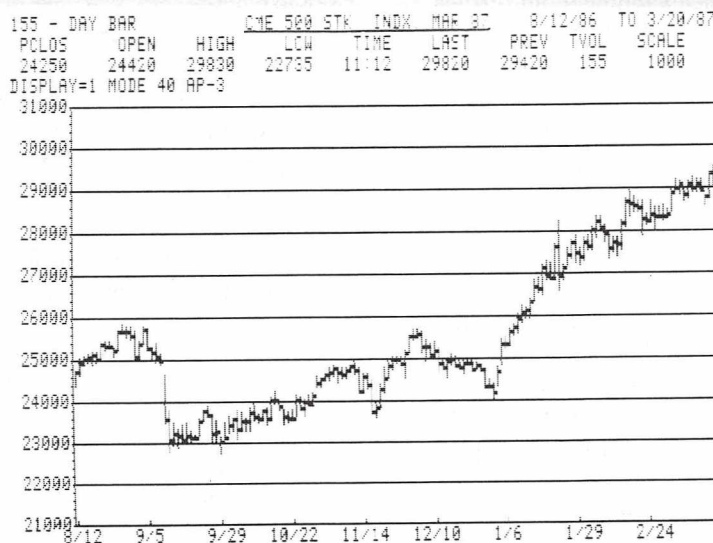
Will the stock market wait until these first signs of trouble appear or will it, in a most characteristic way, anticipate these events? We think the latter.

The financial bubble has entered the final stages. In the last phase of this game of musical chairs, we played (see last month's *FC&CC* on the stock market), won, and now have withdrawn. Once in a bubble, there is no telling how high is high. But the top is a relatively unimportant event (unless you happen to be long that very day). What is important is how deep the subsequent decline will be. And how much trouble is it forecasting? And how much damage, in turn, will it cause?

Rational investors, beware. Of the consequences.

STRATEGY: Liquidated previously established long positions at around 29100, basis March '87 S&P, accepting 1500 points profit. Advised the short side at the same levels and were subsequently stopped out as per our 29550 stop, good anytime (see *Hotline Update*). We remain sidelined.

Chart 1



Crude Oil

Atmospherics versus economics: The long-term view

Worried that Opec is incapable of supplying the oil market with the desired level of atmospherics, the Reagan Administration has begun to produce its own. We first suspected that something new and important was in the offing when Interior Secretary Donald Hodel appeared on the NBC "Today" show (Feb. 18, 1987), and announced that we would face "an energy crisis within the next two to five years." Our suspicions were confirmed during a private breakfast meeting that Secretary Hodel had with Warren Brookes, the nationally syndicated economic columnist, and me on February 26. When Energy Secretary John Herrington sent President Reagan a 240-page (excluding appendices) *Energy Security* report on March 17, what was discussed over breakfast became public.

Although it is important to monitor atmospherics closely — since they can influence the market's "tone" and the course of energy policy development, which can, in turn, affect fundamentals — we must not lose sight of crude's underlying fundamentals. So that we don't lose our way, we focus, once again, on these underlying fundamentals (see *FC&CC*, Feb. 15, 1987).

However, before we turn to an analysis of the long-term economic forces that will push Opec producers to increase their output, we are obliged to comment on the Department of Energy's *Energy Security* report. The report asserts that the degree of dependence on imported oil determines the degree to which the United States is vulnerable to supply disruptions. To put it mildly, this premise is a sophism.

In economic terms, vulnerability means vulnerability to the effects of significant price increases. If there is a supply disruption and international oil prices rise, domestic prices must change by an identical amount, regardless of whether we import all or none of our oil. If domestic prices didn't rise by as much as international prices, an arbitrage opportunity would exist, and the "low"-price domestic oil would move to the "high"-price international market. This process would continue until the differentials between domestic and international prices (net of transport costs and quality differentials) were eliminated. This reallocation of oil would occur and domestic prices would rise by the same amount as international prices — regardless of the degree of import dependency — because the consuming nations in the West have agreed to an International Energy Agency arrangement to share their oil in case of emergencies. This arrangement implicitly precludes the imposition of export controls, which if imposed, could block the movement of "low"-price domestic oil into the "high"-price international market. In consequence, the efforts to reduce vulnerability by reducing dependence cannot have the effects advertised in the *Energy Security* report.

Now we turn to the task of analyzing long-term market fundamentals. The current economic production rate for oil

is determined by the following equation: $P - V = MC$, where P is the market price of a barrel of oil, V is the present value of a barrel of reserves, and MC is the marginal recovery cost of a barrel of oil. To determine the present value of a barrel of reserves (V in our oil production equation), we must forecast the net profit that would be received from liquidating a barrel of oil in the future, rather than now, and discount this net profit figure to present value. The determination of discount rates is, therefore, of great importance in determining the level of current production. If discount rates are high, the value of reserves (V) is lower than it would be with low discount rates, and the gross value of current production ($P - V$) is higher than it would be with low discount rates. In consequence, high discount rates justify higher levels of current production than would prevail with low discount rates.

In the Feb. 15, 1987, issue of *Friedberg's Commodity & Currency Comments*, we demonstrated that producers' discount rates increase when the perceived risk of having their property expropriated increases. Given the nature of the tensions in the Middle East, it is clear that the risk of property expropriation is higher than it would be without the tensions. In consequence, discount rates are higher, the value of oil reserves (V) is lower, the gross value of current oil production ($P - V$) is higher, and economic production rates should be higher than they would be without the threat of property expropriation.

We now address the following question: Are there factors (in addition to the threat of property expropriation) that give rise to high discount rates for oil producers in the Middle East (particularly Saudi Arabia), low values for reserves (V), and high gross values ($P - V$) for current production? If the answer to this question is "yes," we can conclude that it is economic for oil producers in the Middle East to tilt their production toward the present and away from the future.

The discount rate used to determine the value of oil reserves (V in our oil production equation) includes a risk premium. The risk premium can contain various elements. For example, the risk of property expropriation is an element that we analyzed in the Feb. 15, 1987 issue of *FC&CC*.

Another element that can affect risk premiums is the degree to which one's portfolio is diversified. That is, the degree to which returns on one's portfolio move in step with the general market. If, for example, a 1.0 increase (decrease) in the return on the market results, on average, in a 1.0 percent increase (decrease) in the return on a particular portfolio or asset, we can say that the particular portfolio or asset is perfectly diversified. In consequence, the risk premium associated with that particular portfolio or asset should not include a risk element because of the lack of diversity. It should be mentioned that the only risk of holding a particular portfolio

or asset, in this case, would simply be the risk associated with the general market.

Now, consider Middle East oil producers, like Saudi Arabia. The Saudis don't hold a well-diversified portfolio because almost all of their income is derived from oil or oil-related investments. This lack of diversity in their portfolio adds about 10.4% to their risk premium (see Chart 2). In consequence, the discount rates used by the Saudis to value reserves (V in our oil production equation) should be 10.4% higher than they would be if the Saudis had a well diversified portfolio.

The implications of this finding are profound. With high risk premiums, which are caused by the nondiversified nature of their particular asset holdings, Opec oil producers have higher risk-adjusted discount rates than would be the case if they had well diversified portfolios. In consequence, the value of reserves (V) is lower and the gross value of current production (P - V) is higher. This means that the underlying economic fundamentals favor more current production because its gross value (P - V) exceeds its marginal recovery cost (MC). Increased production will not only allow producers to maximize the value of their oil resources but it will also allow them to liquidate their investments in oil reserves and use the funds received to make non-oil investments. This will allow producers to begin the process of diversifying their portfolios.

— By Steve H. Hanke

A rerun of mid-1985: The short-term view

In May through August 1985, Opec flexed its muscle, cutting output to as low as 14.1 million barrels per day (b/d) from 16.7 million b/d in the early part of the year. The Saudis, at that time the official swing producers, bore the brunt of the cutback. In August 1985, Saudi Arabia's oil production hit an all-time low of 2.2 million b/d, a far cry from its quota of 5 million b/d and its capacity of 10-12 million b/d. The drop in production was *involuntary*: The Saudis were merely *reacting* to market forces. Competing free market supplies were preempting Saudi sales. For fear of breaking the \$28/barrel price, the Saudis were forced to hold back supplies.

The rest of the story is well known. Sheikh Yamani understood that the Saudi role of swing producer would lead to zero output. Alarmed at the extraordinary loss of revenues, King Fahd ordered an historic retreat: The Saudis would no longer be swing producers. As their production rose back to 4-6 million b/d (by February 1986), oil prices collapsed, hitting \$12/barrel. Later in the year (July-August) Saudi production increased further, to 6.2 million b/d, and prices crashed to as low as \$8/barrel.

Panicky, King Fahd had a change of heart. He fired Yamani, installed Nazer and moved back, reluctantly (and, at times, denying it) to the old swing producer role.

Prices are no longer \$28/barrel. But even at \$18/barrel, Opec has difficulty in moving more than 14.8 million b/d. And, of course, the Saudis are back to a 2.5 million b/d output.

How does the market mobilize free supplies that com-

Chart 2

Portfolio Diversification Risk Premiums

Given:

1. RP = risk premium,
2. RM = expected real return in general market (10.0% from historical market data),
3. RM = risk-free real rate of return (2.0% from historical data on T-bill yields minus inflation).
4. Beta = a measure of the sensitivity of real rates of return on a particular portfolio or asset to general market movements (Beta = 1.0 for a perfectly diversified portfolio or asset.) (Beta = 2.3 for Saudi Arabia's portfolio.)

Steps:

1. $RP = \text{Beta} (RM - RF)$
2. The risk premium for the perfectly diversified portfolio is:
 $RP = 1.0 (10\% - 2\%) = 8\%$
 (Note this is equal to the risk premium for the market as a whole because the Beta equals 1.0.)
3. The risk premium for Saudi Arabia's portfolio is:
 $RP = 2.3 (10\% - 2\%) = 18.4\%$
4. The added risk premium because Saudi Arabia's portfolio is not well diversified is:
 $(18.4\% - 8.0\%) = 10.4\%$

Conclusion:

1. The Saudis must add 10.4% to any discount rate they use to value oil reserves. This results because their portfolio is not well diversified.

Note: This analysis follows that of Professor M. A. Adelman, "Oil Producing Countries' Discount Rates," *Resources and Energy*, December 1986.

pete with Opec? Via the backwardation. As explained in many previous issues, nearby premiums encourage holders of temporarily idle supplies to "lend" these to the market. These supplies can be repurchased for later delivery at a substantial discount; alternatively, the lender may take a view of the market and speculate that months from now, it will be able to cover these "loans" at a favorably lower price.

In 1985, the backwardation reached an incredible \$4.25/barrel or somewhere around a 13.5% discount to spot prices. As Chart 3 shows, from September 1984 to September 1985, the six-month backwardation moved to an attractive \$2.50/barrel. The lure of this potential profit proved irresistible: Idle spot supplies were "lent" or sold to the market, and the Saudis retreated.

In 1987, events are following the same script. Chart 4 shows a sharp steepening backwardation accompanying a sharp output cutback. At Friday's expiration of the April '87 contract, the six-month backwardation stood at \$1.10/barrel, nearly a 6% discount from spot.

As the backwardation widens, output losses, particularly for Saudi Arabia, will become intolerable. There is no shortage of idle supplies; the International Energy Agency estimates that stocks as of April 1 were 428 million tons, 15 million tons more than last April 1 and a 98 forward day supply.

It is no longer a question of *if* but rather *when* will the Saudis give up, once more, their swing producer role. At 2.5 million b/d the Saudis are earning, at most, \$45 million per

day. In August 1985, at 2.1 million b/d they earned \$59 million per day. Then they were only a few weeks away from changing their mind. Can they be very far off now?

Embarrassed and with his back to the wall, King Fahd may yet wait one to two months more, hoping for some miraculous upturn in consumption or some excuse. When the change comes, it will be devastating: The Gulf states, led by Saudi Arabia, will flood the world with oil. The price will plunge below \$5/barrel. Every major producer will shut off production. Only then will idle supplies disappear.

Prepare for the Act II of the Great Oil Bear Market of the '80s.

STRATEGY: Remain short deferred contracts. Chart 5 indicates that the bears have not endured much pain in recent months if they followed our advice. We are very close to complete victory.

Chart 3

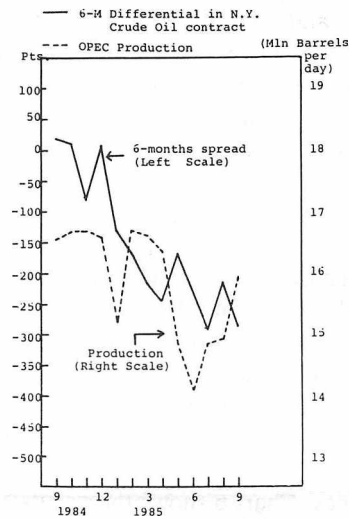


Chart 4

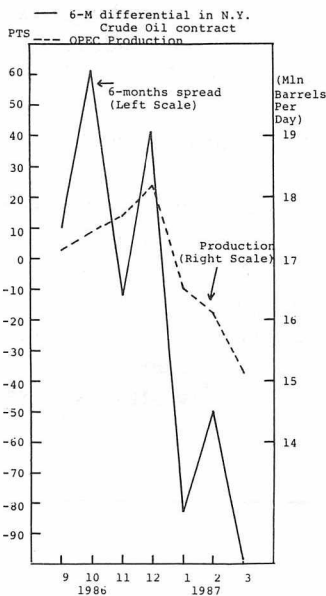
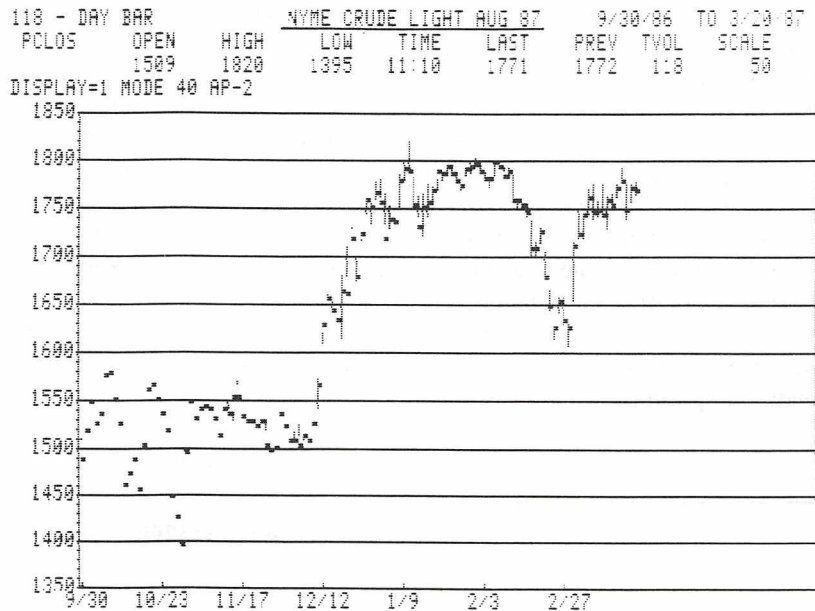


Chart 5



On the march

Government is the only institution that can take a valuable commodity like paper, and make it worthless by applying ink.

—Ludwig von Mises

As we noted in "Printing (a lot of) money" (see *FC&CC* December 14, 1986), the Fed has been applying a great deal of ink to a lot of paper. Since the last week in February 1986, the money supply, measured by M1, has been growing at an annualized rate of about 17%. It shouldn't be surprising, therefore, that we are beginning to observe signs that inflation is on the march.

The most recent figures for the Consumer Price Index

show an 8.7% annualized increase for the month of January. In addition, the Center for International Business Research at Columbia University reported in its March 10 report that "the leading inflation index took a dramatic jump to 113.1 in January from a revised 110.5 in December. The index grew at an annualized rate of 8.1%, far larger than at any other time in the past two years."

Even though these data represent only one month, they should give rise to serious concern, given the past year's explosive monetary growth. More ominous than the January data, however, are the trends that are developing in inflation indicators (see Chart 6). To understand the trends, recall our article of June 22, 1986, "Monetary protectionism equals in-

flation." To blunt the Congressional drive towards standard protectionism (tariffs and quotas), the Reagan Administration, in the person of Treasury Secretary James A. Baker III, encouraged the Fed to engage in monetary protectionism last year. The Fed followed through by opening up the money supply valves, which caused the dollar to tumble, if not free-fall at times.

Monetary protectionism was advertised as a means to lower the value of the dollar (which it has done), reduce the trade deficit (which it hasn't done), and blunt calls for protectionist legislation (which it hasn't done). Monetary protectionism wasn't advertised as a harbinger of inflation (at least outside the pages of *FC&CC*; see "Dollar down, inflation up" Dec. 14, 1986). However, the fall in the dollar has begun to increase the price of imports and reduce the level of foreign competition in the US. This has allowed domestic producers to increase their prices. Chart 6 shows the trends and linkages between changes in import prices and changes in the Consumer Price Index. It is these trends and linkages (higher import prices equal higher consumer prices) that give us more concern about a reignition of inflation than the January price or leading inflation index data alone.

With the lower valued dollar, higher import prices, and reduced foreign competition, domestic producers have increased their prices (see Chart 6). In consequence, domestic labor has demanded higher wages, which has increased unit labor costs. This is of particular importance because, for the past 15 years, rates of change in unit labor costs have been a very good indicator of rates of change in the Consumer Price Index. For example, rates of change in consumer prices typically exceed those for unit labor costs by about 1%. As do the trends in import prices and consumer prices, the unit la-

bor cost trend gives us cause for concern. In 1986, the quarterly changes in unit labor costs for nonfarm businesses were -1.2%, +1.8%, +2.6%, and +5.1%, computed on an annualized basis.

Other labor market data support the observed upward trend in unit labor costs. For example, the "Help Wanted Index," which is published by the Conference Board, is running at near record levels. This results from the fact that the US is facing a growing labor market squeeze in two sectors. In the high-tech sector, the US is creating new skilled job openings more rapidly than it is producing the skilled people to fill the newly created job slots. In consequence, wages in this sector are being bid up rapidly. In the low-tech sector, which is usually "manned" by youngsters, the number of youngsters entering the labor force has actually begun to fall. In consequence, unskilled labor is in short supply, wages in the low-tech sector are being bid up, and most unskilled labor is being paid considerably more than the minimum wage.

With ominous signs that inflation appears to be on the march, it is useful for commodity traders to reflect on past relationships. When inflation heats up, commodity prices move up much more rapidly than general price indexes for final products, such as the Consumer Price Index and the GNP deflator. Commodity prices also move up faster than general price indexes for intermediate products, such as the Producer Price Index. In addition, when inflation heats up, the volatility of commodity prices increases. While this increased volatility and associated increased uncertainty play havoc with the economy, they do create profitable trading opportunities.

The prospects for an accelerated rate of inflation in coming months have serious implications for *interest rates* and *gold*. See the following discussions on interest rates and gold.

— **By Steve H. Hanke**

Chart 6

Inflation Indicators					
Item	Import Price Index Last 12 months (Dec. 85-Dec. 86)	Import Price Index Last 6 months Annualized (July 86-Dec. 86)	Consumer Price Index 6 months ending July 86 Annualized	Consumer Price Index 6 months ending Jan. 87 Annualized	Consumer Price Index Jan. 87 Annualized
All Items	-8.7%	+6.8%	-0.5%	+3.5%	+8.7%
All Items Except Energy	8.5	+7.4	+3.5	+4.3	+6.2
Food	+2.4	+1.1	+3.2	+5.2	+6.2
Clothing	+3.4	+5.5	-0.4	+3.2	+4.9
Autos	+14.9	+10.6	+5.6	+5.9	+4.9
Household Appliances and Furnishing	+5.8	+7.0	+1.1	+2.4	+7.4
Furniture	+7.9	+4.0	+0.7	+2.5	+8.7

Interest Rate Futures

It is becoming increasingly difficult to justify long-term bond yields of 7.50%-7.75%, the narrow range in which bonds have settled for the past year. Balance of payments considerations are essential for understanding the reasons why this is so. A current account deficit implies a shortage of domestic savings in the face of *relatively strong* investment demand. The obvious cure is a rise in domestic interest rates to dampen consumption and spur more savings. At the same time, the US must be able to attract inflows of foreign capital to finance the "temporary" current account imbalance.

However, real interest rate differentials between the US and its major creditor countries (particularly Japan and West Germany) have narrowed. To keep the foreign capital flowing into the US (with inflation in the offing), the Fed will have to allow rates to, at the least, drift upwards, so that US real

yields can be maintained.

So it can be demonstrated that a *rise* in interest rates accomplishes a dual purpose: It lays the groundwork for narrowing the current account deficit, and, at the same time, makes it attractive for foreigners to continue lending their savings to the US, overcoming their fear of further devaluation.

STRATEGY: *Remain short June '87 Eurodollars. Maintain stops at 94.10. For the past four weeks, T-bonds have traded in an extremely narrow range of 30-40 thirty-seconds, triggering our stops but remaining within the same area. Positions should be reinstated; in order to avoid further whipsaws, we are allowing for a more generous stop (thus increasing, of course, the risks), after rolling over the positions to the June '87 contract. Place protection at 105, good anytime.*

Chart 7

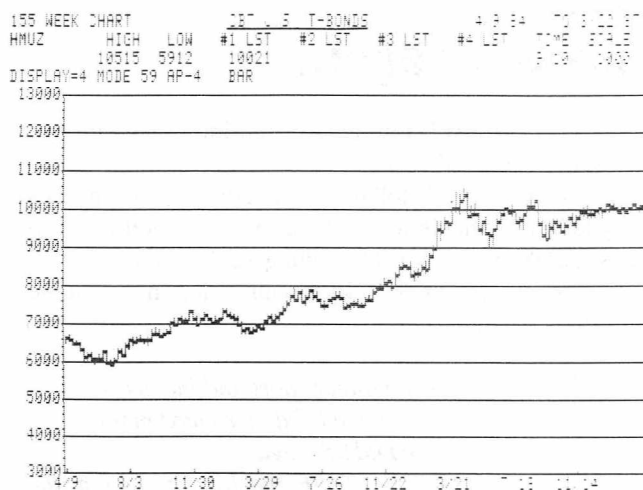
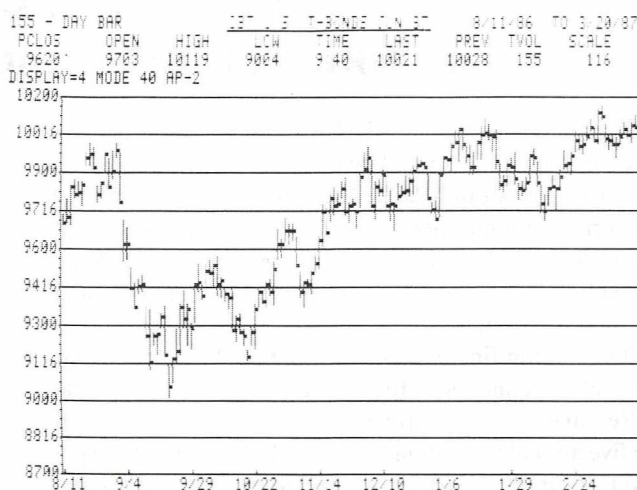


Chart 8



Precious Metals

The bearish arguments are numerous and quite obvious: flagging gold coin sales (in the US and Japan), the absence of official Japanese buying (as in 1986, when they easily took up more than half of all the newly mined gold in the world), "heavy" Russian sales (presumed to take place, because of falling oil and gas revenues), the relative attraction of financial assets, and so on.

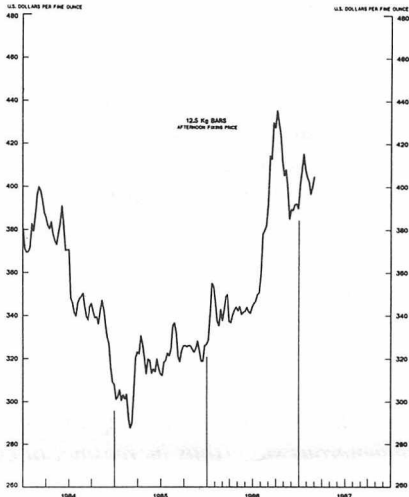
Impervious to the bears, the bullion market appears to be marking time just above \$400/oz., a pattern that began nearly six months ago, after climbing \$100/oz. (or 30%) almost vertically (see Chart 9). This high-level consolidation, as technicians prefer to call it, is building up the "strength" required to catapult gold before too long into the \$500-\$600/oz. zone.

The fundamentals are supporting just such a move. First, our US external liabilities valuation model (see Chart 10 and previous issues for an explanation) continues to move into new high ground, now \$620/oz. Second, our view is that inflation is about to accelerate. As the statistics begin to bear out this fact, investment psychology, now enamored with financial assets, will be shifted to the precious metals complex, helping to sustain what will become a most spectacular bull market.

STRATEGY: *Raise stops on long-term gold positions to 389 from 375, close only, basis nearby Comex contracts. Maintain stops at \$480/oz., basis nearby platinum and 5.51, basis July '87 silver, close only.*

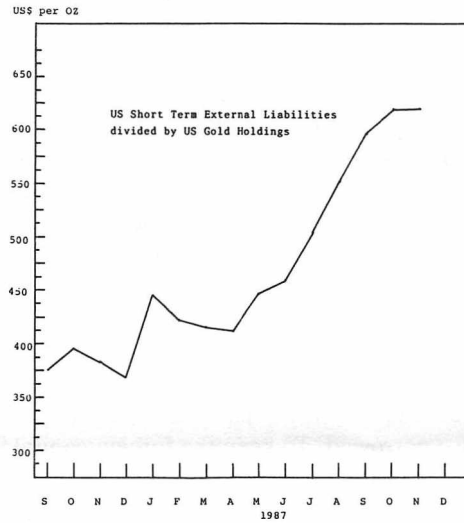
Chart 9

PRICE OF GOLD IN LONDON
AVERAGES FOR WEEK ENDING WEDNESDAY



Source: Federal Reserve Bank of St. Louis.

Chart 10



Currencies

US dollar coming under pressure again...

The breathing spell enjoyed by the US dollar since mid-January is rapidly coming to an end. The high level, secretive agreements of the G-5 not only lacked serious substance but even lacked serious commitment: The US and its allies did not undertake to defend fixed parities. Instead, they tried to keep the market guessing, losing whatever benefit can be gained from joint intervention.

All deception finally comes to an end. The US current account deficit cannot be redressed without some drastic measures. Relative economic growth in the US must be lowered four to five annual percentage points below the growth experienced by its trading partners. With economic growth in the rest of the world (principally Japan and Western Europe) grinding down to a paltry 2.5%, the US must enter an outright re-

cession to effect a substantial external improvement (see previous issues of *FC&CC*).

Technically, the US dollar has spent the past two months moving laterally, unable to break out of its long-term downtrend (see *\$DM*, Chart 16). This telling weakness is sufficient testimony to the market's lack of confidence in a genuine stabilization program.

STRATEGY: Barring another short and inconsequential test of the DM1.87-1.89 area, the US dollar's next major move is downwards, towards the DM1.50 area.

Buy June '87 DM, June '87 SF and June '87 yen, at the market; place stops at 53.40, 63.75, and 64.85 respectively, close only.

Chart 13

137 - DAY BAR CME JAPANESE YEN JUN 87 9/5/86 TO 3/20/87
 PCLOS OPEN HIGH LOW TIME LAST PREV TVOL SCALE
 6484 6707 6121 2:04 6636 6627 136 100
 DISPLAY=4 MODE 41 AP-3

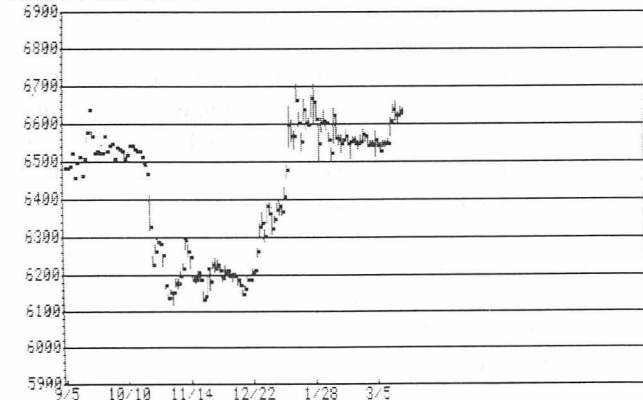


Chart 14

148 - DAY BAR CME SWISS FRANCS JUN 87 4/24/86 TO 3/20/87
 PCLOS OPEN HIGH LOW TIME LAST PREV TVOL SCALE
 5486 5800 5406 2:05 6551 6551 147 200
 DISPLAY=4 MODE 41 AP-2

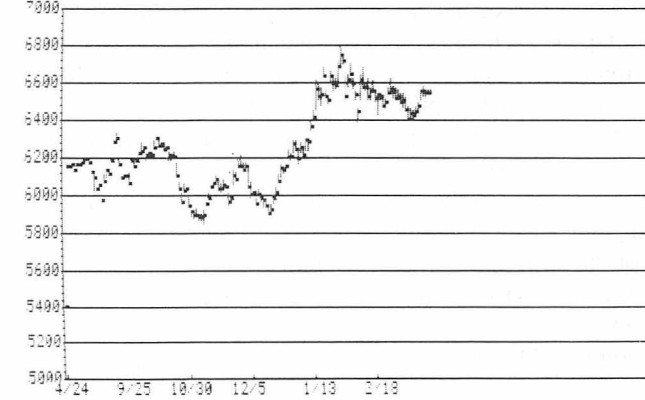


Chart 15

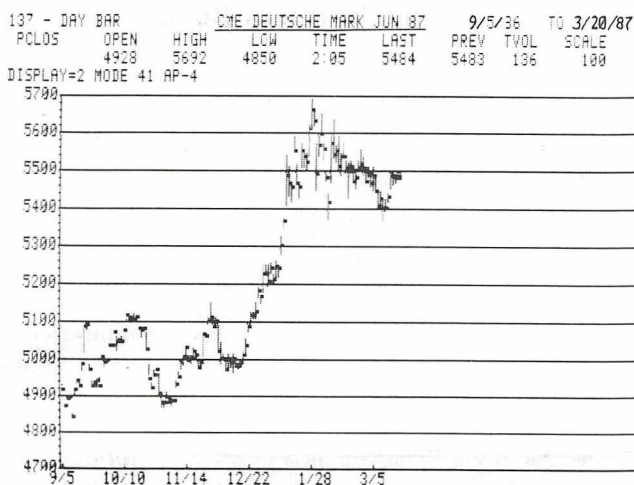


Chart 16



Canadian dollar

Stopped out, as per last month's market letter, around 75.60 on our latest attempt to buck the irrational uptrend in the CD\$.

STRATEGY: Remain sidelined but alert to a new sale recommendation, via our Hotline Update service.

Friedberg Capital Markets

The first capital market to introduce the floating rate concept to debt instruments was the Eurobond market. By definition, a floating rate note (FRN) is an international bond issued for medium- and long-term maturities with a rate of interest that fluctuates with respect to the Eurodollar interbank reference rate. In most cases the reference rate for FRNs is the London Interbank Offered Rate (LIBOR). Floating rate notes usually pay semi-annually or quarterly LIBOR plus a margin.

There are two distinctly different sectors of floating rate notes: the dated issues and the perpetuals (undated). Lately the international press has highlighted the problem with the perpetual FRN market. Perpetual FRNs are essentially the same as other FRNs except that they have no maturity date, and therefore the principal is never repaid. The perpetual FRNs were issued mostly by banks in lieu of equity, as per a recent Bank of England ruling. Japanese banks have been the principal buyers of these notes.

Despite an excellent initial reception, these bonds have fallen considerably since the turn of the year. Banks have been reluctant to buy them as rumors have spread that these perpetual notes may not, after all, be used as primary capital if they are held by other banks. Retail accounts have shunned them because of the obvious: the uncertainty associated with not ever recovering the principal.

Large dealer losses in the perpetuals have caused some liquidation of FRN inventories, including dated issues. As a

result, dated FRNs now are trading at 3-4-point discounts, which represents a large discount for value-oriented buyers. These unwarranted discounts, and the fact that purchasing fixed-rate debentures at the low end of the interest rate cycle is much too speculative, create an exciting investment opportunity.

For the more conservative investor, Friedberg Capital Markets makes available two dated FRNs that have the most protective features available. These FRNs pay interest and adjust their interest rate quarterly, at a rate of 1/8% over three-month LIBOR, with a floor interest rate of 5.25%. The most remarkable characteristic of both these issues is that they are overcollateralized with US government backed certificates and T-bills. A trustee holds 150% the size of the issue outside the grasp of any creditor (including the FSLIC). If the borrower fails to make a payment, the trustee sells the collateral and pays the holder. These issues also carry in their indenture a provision that forces the issuer to continually maintain a Moody's triple-A rating. At this time they are priced to yield 6.69%, a substantially higher yield than is obtainable for US dollars at Canadian chartered banks.

To the more aggressive investor, we offer a Wells Fargo FRN, rated AA, and paying 1/8% over one-month LIBOR (pays monthly), trading at an attractive 3-point discount. This discount brings their effective margin over LIBOR to 41 basis points, making the total yield 6.71%. Wells Fargo is one of the most profitable money-centre banks in the US and ranks number 15 in size.

CONCLUSION: Floating rate notes allow investors to enjoy competitive money market yields while eliminating the risk of capital loss should interest rates rise. The present disarray in the perpetual FRN market has created great opportunities to purchase dated FRN issues.

Chart 18

Foreign Currency Bonds

DATE: March 20, 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%	98 1/2	99 1/4	18.28	16/6/86-16/6/87		
HONDA INT'L 20/9/89 16 3/8%	95	95 3/4	18.27	20/6/86-20/9/87		
HONDA INT'L 28/5/90 16%	94	94 3/4	17.86	28/11/86-28/5/88		
TOURIST HOTEL CORP.(N.Z.) 4/6/93 zero coupon	40 1/8	40 7/8	15.55	matures 4/6/93		
BANK OF NOVA SCOTIA 15/9/89 18 1/4% RRSP eligible	100 1/2	101	17.76	15/5/86-15/9/87		
WELLS FARGO (semi-ann.) 12/5/89 16 1/8%	94 1/2	95 1/4	19.79	12/11/86-12/5/87		
KODAK (semi-ann.) 15/2/89 17%	98 3/4	99 1/2	18.02	12/2/86-15/8/87		
TORONTO DOMINION 2/4/90 18% RRSP eligible	100 1/2	101 1/4	17.43	2/4/87-2/4/88		
AUSTRALIAN DOLLAR DENOMINATED BONDS						
CAN. IMP.BANK OF COMMERCE 13/3/91 13% RRSP eligible	96 1/2	97 1/4	13.93	13/3/86-13/3/87		
DEUTSCHE MARK DENOMINATED BONDS						
REPUBLIC OF PORTUGAL 19/6/94 6 5/8%	100.85	101.60	6.33	19/6/86-19/6/87		
GOVT. OF BELGIUM 29/4/96 5 1/4%	94.35	95.10	6.22	29/4/86-29/4/87		
QUEBEC HYDRO 1/5/96 5 1/4% RRSP eligible	94 1/2	95 1/4	6.19	1/5/86-1/5/87		
SWISS FRANC DENOMINATED BONDS						
GOVT. OF AUSTRALIA 30/10/98 5%	102 1/2	102 1/2	4.74	30/10/86-30/10/87		
JAPANESE YEN DENOMINATED BONDS						
GOVT. OF CANADA 23/7/93 5 5/8% RRSP eligible	106	106 3/4	4.37	23/7/86-23/7/87		
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)	99.80-	100.10	6 5/8%	18/6/87
LINFIN SAVINGS & LOAN (fully collateralized)	14/11/95	pays 1/8% over 3 months LIBOR (quarterly)	99.72-	100.02	6 11/16%	18/5/87
WELLS FARGO (fully collateralized)	3/4/2000	pays 1/8% over 1 month LIBOR (monthly)	97.45-	97.75	6 9/16%	21/4/87

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

The Exotics

New Zealand dollar

The New Zealand government's progress in reforming the economic environment is stalling, after an auspicious start in which the Lange government was able to bring down the fiscal deficit to 6.9% in 1984-85 and to 4.1% in 85-86 from 9% of GDP.

The fiscal gap is expected to widen to 6.5% for the year ending March 1987, and probably will remain at this rarefied level for at least another year. This is disappointing in view of the fact that fiscal discipline has been held up to be one of the cornerstones of the reformation. It should be noted that the 1986-87 budget had forecast a NZ\$2.45 billion deficit; in fact, it already has been revised upward to NZ\$2.9 billion. What is most disturbing about the fiscal trends is the fact that spending has climbed more than 21% for the first 10 months of fiscal 1986-87 over the previous fiscal year, substantially above the rate of inflation, which is estimated to have averaged 15% over the period.

On the monetary front money supply growth remains still excessive with the broad M1 rising at an annualized 15.9% and the narrow M3 rising at 17.8% annualized. This monetary expansion is fueling a financial boom of somewhat unhealthy

proportions while sustaining a consumer boom that is bloating imports. Very high interest rates (overnight to three-month money is at 25%-28% per annum) give the impression of a tight monetary policy. The reverse probably is true; easy monetary policy fuels a lending boom, which when combined with fiscal borrowing, lifts the demand for credit well above the nation's genuine savings supplies. As a result, New Zealand is forced to tap foreign savings, running a current account deficit, which not coincidentally equals 6.5% of GDP. This phenomenon (excessive domestic spending) is the root cause of the country's chronic current account deficit.

The rest of the world has been glad to lend New Zealand its savings. Real interest rates are attractive (at least 10% per annum in the short end and at least 5% per annum in the three- to five-year range *for the moment* — and possibly a great deal more if, as expected, inflation does drop to the 8%-9% range by year end).

Even though Roger Douglas, the finance minister, speaks a super-attractive language, New Zealand's total foreign debt, now at NZ\$33 billion, already is equal to approximately 70% of GDP. How long will foreigners acquiesce in augmenting their direct claims on New Zealand at a rate of 6-7 percentage

points per annum? We believe not much longer; probably just enough to get the Lange government reelected later this year, and to demonstrate that they clearly want to implement a rigorous program of fiscal and monetary discipline.

In the near term the currency remains well supported by the willingness of foreign investors to lend money to New Zealand at momentarily attractive interest rates. Furthermore, New Zealand's rate of inflation probably will drift towards the OECD average (although it probably will not fall below 8% per annum) now that the effect of the GST tax is dissipating. This means that nominal long-term rates still have some

scope on the downside and are likely to produce a bull move in the medium- and long-term dated bonds. It then follows that foreign capital may accelerate its buying program to take advantage of the possibility of earning a capital gain on the bonds. This acceleration of inflows also could spike the New Zealand dollar well above the US60¢ level. We warn, however, that this fool's paradise may not last years unless deep structural reforms are carried out.

STRATEGY: Remain long New Zealand dollar, currency and bonds, both vis à vis US\$ and DM.

Chart 19

YEAR	NEW ZEALAND DOLLAR PER US DOLLAR (PERIOD AVG.)	U.S.		BASKET	
		1970 = 1.00	1978 = 1.00	1970 = 1.00	1978 = 1.00
1967	1.3554	0.8253	1.1096	0.8739	0.9612
1968	1.1170	1.0019	1.3470	1.0130	1.1141
1969	1.1152	1.0071	1.3541	1.0093	1.1101
1970	1.1193	1.0000	1.3445	1.0000	1.0998
1971	1.1416	0.9232	1.2412	0.9549	1.0502
1972	1.1952	0.8547	1.1491	0.9248	1.0171
1973	1.3615	0.7354	0.9888	0.8638	0.9500
1974	1.4004	0.7136	0.9594	0.8528	0.9380
1975	1.2157	0.7847	1.0531	0.9456	1.0401
1976	0.9963	0.8663	1.1647	1.0110	1.1119
1977	0.9708	0.8270	1.1119	0.9638	1.0600
1978	1.0378	0.7458	1.0000	0.9092	1.0000
1979	1.0229	0.7390	0.9936	0.9263	1.0188
1980	0.9742	0.7513	1.0101	0.9807	1.0786
1981	0.8700	0.8056	1.0831	0.9978	1.0974
1982	0.7519	0.8507	1.1437	0.9826	1.0807
1983	0.6688	0.9201	1.2371	0.9991	1.0989
1984	0.5785	1.0448	1.4048	1.0800	1.1879
1985	0.4984	1.0877	1.4624	1.0521	1.1572
1986 (1Q)	0.5253	0.9828	1.3213	1.0024	1.1025
1986 (2Q)	0.5555	0.9028	1.2137	0.9511	1.0460
1986 (3Q)	0.5053	0.9679	1.3013	0.9812	1.0792

----- BASKET -----
U.S. 25% JAPAN 28%
AUSTRALIA 26% U.K. 15%
Germany 6%

Above 1.00 = undervalued
Below 1.00 = overvalued

Chart 20

Year	Foreign Assets (Min. US\$)	CURRENT ACCOUNT As % of GNP %	CUMULATIVE 12 QTR. Current Account (Min. US\$)
1970	317	-3.76	-283
1971	547	-0.25	-228
1972	888	+1.74	-88
1973	1139	-0.97	+22
1974	568	-12.82	-1761
1975	55	-8.46	-3092
1976	-98	-5.81	-5772
1977	-231	-4.72	-2664
1978	-234	-2.73	-1980
1979	425	-3.90	-2002
1980	317	-3.48	-2117
1981	729	-5.47	-2984
1982	797	-6.34	-3636
1983	850	-4.36	-3779
1984	1849	-6.61	-3935
1985	1521	-7.45	-3992
1986	2253	-6.42	-4424

Chart 22

SPOT	1 - Month	3 - Month	6 - Month	12 - Month
.5570-	.5475-	.5310-	.5110-	.4795-
.5580	.5485	.5330	.5130	.4845

Chart 21

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

Reserves * + Previous 12-months current Account *** = 4350
(Reserves + 12-months C/A)/ M1 ** = 4350/2286 = 190%

(Reserves + 12-months C/A)/ Broad Money ** = 4350/8474 = 51%

*As at Dec. 1986 ** November 1986 *** 1987 Estimated

Figures in millions of U.S. Dollars

	M1 (Converted to U.S. Dollars)	Broad Money (Converted to U.S. Dollars)
1977	1888	3825
1986 (Nov.)	2288	8474
% Increase (decrease)	21%	121%
Corresponding % increase in the United States	108%	108%

(a) 1986 Imports as percentage of GNP 25.77
(b) 1977-1986 Imports as percentage of GNP 23.21
1986/(1977-1986 average) = (a)/(b) = 100.03

Source: IFS

Forex Rates & Update

<u>Currency</u>	<u>Spot</u>	<u>3-Month</u>	<u>12-Month</u>	<u>Comments vis à vis US\$</u>	<u>Comments vis à vis DM (Spot DM: 1.8300)</u>
*Australian dollar	.6850-.6855	.6685-.6695	.6273-.6288	Buy	Buy
Belgian franc	37.92-37.95	37.96-38.04	38.15-38.28	Neutral	Remain long
*Danish krone	6.88-6.89	6.94-6.96	7.14-7.17	Neutral	Sell
Dutch guilder	2.0685-2.0695	2.0632-2.0647	2.0455-2.0475	Neutral	Remain long
Greek drachma	134.30-134.40	138.50-140.40	154.30-163.40	Neutral	Remain short
Italian lira	1300-1302	1308-1310	1338-1342	Neutral	Neutral
Kuwaiti dinar	.27600-.27615	.27550-.27600	.27365-.27510	Neutral	Remain short
Malaysian ringgit	2.5215-2.5235	2.5015-2.5065	2.4565-2.4835	Neutral	Neutral
Norwegian krone	6.92-6.93	7.05-7.07	7.47-7.49	Neutral	Neutral
Portugese escudo	140.70-141.20	143.20-145.20	150.70-161.20	Neutral	Neutral
Saudi Arabian riyal	3.7490-3.7500	3.7500-3.7540	3.7750-3.7850	Remain short	Remain short
Singapore dollar	2.1420-2.1430	2.1288-2.1308	2.0970-2.1080	Neutral	Neutral
Spanish peseta	128.35-128.45	131.00-131.40	136.35-137.45	Neutral	Neutral
Swedish krona	6.39-6.40	6.47-6.48	6.64-6.66	Neutral	Neutral
Venezuelan bolivar	22.75-22.95	23.50-24.00	25.95-27.35	Neutral	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

Sell

Sell

Buy

Sell

Sell

Buy

Cover

Liquidate

Hotline Update

Flash update, Tuesday, Feb. 17, 2:15 p.m.: Because of unusual market movement in the gold, I will quote the market letter, which was mailed today. Strategy on gold: Traders may wish to stop April '87 gold at 395, good anytime, looking to buy back at 376-380. Long-term investors should place stops at 375, close only.

Flash update, Friday, Feb. 20: In our last newsletter traders were advised to sell April gold on a break below 395, while at the same time we advised long-term holders to remain long regardless of near term weakness. For traders who sold on the break below 395 this week, we advise reinstating immediately long gold positions at the market. Long-term investors should now add to their positions.

Tuesday, Feb. 24: No new recommendations.

Friday, Feb. 27: No new recommendations.

Tuesday, March 3: No new recommendations.

Friday, March 6: One new recommendation: Raise stops on March S&P to 279.75, close only.

Tuesday, March 10: We would like to reiterate the necessity of rolling forward short positions in crude oil to at least August and beyond. The backwardation is likely to widen rather drastically in the next few weeks.

Friday, March 13: We advise liquidating at the market all long S&P futures positions, realizing substantial gains. A bearish stance is now in order. Sell June S&P at market. Place stops at 295.50, basis June, good anytime. To reiterate this week's reminder, we are now short the crude oil in the deferred months only.

Tuesday, March 17: No new recommendations. One reminder: For all short S&P positions, the stop remains 295.50, basis June, good anytime.

Friday, March 20: No change or new recommendations.

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