

# FRIEDBERG'S

## COMMODITY & CURRENCY COMMENTS

Friedberg Commodity Management Inc.



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### Gold: the best is yet to come

When last month we suggested that "the market should find excellent support above \$440/oz.," little did we imagine the laborious route taken by the yellow metal to reach this level (see Chart 1)!

On June 22, it breached this support, closing at 437.40, basis spot Comex. On the very next day, however, the market regained the \$440 level and has managed, thus far, to trade above it. Not coincidentally, this area rests just *above* the previous peak attained in October 1986 (see Chart 2). And so it is in bull markets: Resistance areas become the next support areas.

The latest bear raid, in particular the severe shakeout of June 22, was aggravated by a well-featured article, in a prominent financial publication, entitled "Glut in Gold?" The author made the correct observation that thanks to technology, production had been rising rather dramatically (see Chart 3) and was likely to continue rising for the foreseeable future, although no overall estimates were given.

Extrapolating recent gains, we could make a case that future production would increase 50 tons yearly. To err on the conservative side, we will grant a 100-ton yearly average for the next decade. Can it be considered a *glut* of gold? How serious, if at all, is the threat to rising prices?

First, a perception of what is 100 tons of gold. At today's prices, a mere \$1.4 billion: That's the amount of money spent by a US robber baron on a *medium-sized* acquisition (not, of course the \$6.2 billion Beatrice Foods acquisition); the amount of dollars spent by the Bank of Japan in *one day* last April to support the collapsing dollar; the increase in the narrowly-defined US money supply over *five days* of the last 365 days. Obviously, not a great deal of change.

But would this increase, at the *margin*, be significant? Dividing 100 tons by current free world production of 1,275 tons, we obtain a 7.8% increase, *at the margin*, for the first year (and, of course, less every subsequent year, as total production increases and the denominator grows larger). Entirely forgotten is the fact that from June 1976 to May 1980, the IMF sold 23,514,000 ounces, or approximately 732 metric tons, of gold in regular auctions (see Chart 4). This total represented 183 metric tons per year when yearly production was averaging only 950 metric tons, nearly a 20% marginal in-

crease in supplies!

Did prices collapse? Not at all. As Chart 4 indicates, the auctions took place at ever-increasing prices, from an initial \$126/oz. to a final \$504.90/oz., with a peak of \$712/oz. reached just a four short months before the end of the disposal program. What is more, the IMF also distributed directly to its members an equivalent amount of bullion, some of which may have found its way into the free markets of Zurich and London.

Even if member countries received the gold and did not avail themselves of the opportunity to turn it into cash, Central Bank *buying* of gold was correspondingly diminished. Finally, during that same period, the US government sold gold in auctions held at irregular intervals, totalling some 17 million ounces, or 535 metric tons. The bulk of the sales took place in 1978 and 1979, thus adding a further 268 metric tons per year (!) to world supplies. Chart 5 shows that these sales were made at sharply rising prices.

Can there be any doubt of the old market maxim that "supply creates demand"? Increased gold supplies will widen the interest in the metal, testing the marketing ability of the many producers. Rising prices will feed demand, which in turn will lift prices and make gold a "favorable" investment vehicle (this is one of the wonderful properties of rising prices).

Our dynamic gold model, which attempts to price gold at a level that will equate the nominal value of US gold holdings ("Fort Knox") with its net (short-term) external liabilities has just reached a new all-time high a result of skyrocketing deficits. In the early stages of a trend, whether it be a bull or bear market, the gold market reacts cautiously to the underlying fundamentals and it will tend to lag the theoretical value by a considerable amount. Chart 6 depicts the market value/

#### In this issue

We stand aside in silver and platinum, preferring the safety and certainty of gold. We favor the short side of T-bonds, sell S&P, buy copper and the Aussie buck. As for oil, we stand on the sidelines, waiting for the Saudis to show some displeasure... Contributions by Albert D. Friedberg, Steve H. Hanke, Daniel A. Gordon, and Michael D. Hart.

theoretical value ratio since 1973 (one year after gold prices were unfixed and sufficient time elapsed to adjust to the new reality). Once again, gold is trading at the lower end of this theoretical valuation (compare to 1977).

We expect our gold valuation model to continue to show price increases into the foreseeable future (a function of excessive US spending relative to income). At the same time, we expect the gold market ultimately to narrow its discount to theoretical value. In conclusion, gold is in the early stages

of a long and powerful bull market that will rise well above the old, historic highs.

**STRATEGY:** Long-term investors should not disturb long positions, regardless of near-term price weakness.

Short-term traders were advised to liquidate long positions on a close below 450.50, basis August '87. (See Hotline Update). Keep posted for a reentry recommendation.

Chart 1 - COMEX GOLD JUN 87

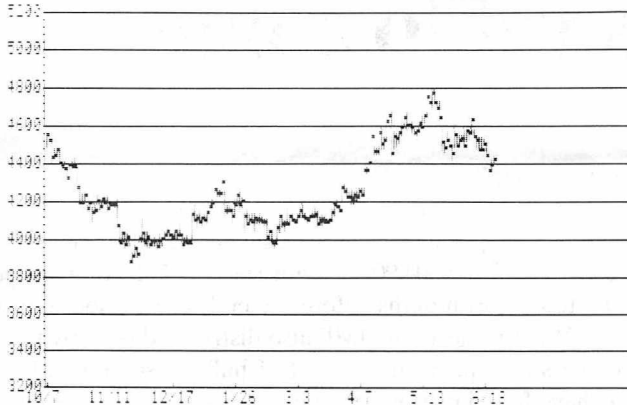


Chart 2  
PRICE OF GOLD IN LONDON  
AVERAGES FOR WEEK ENDING WEDNESDAY

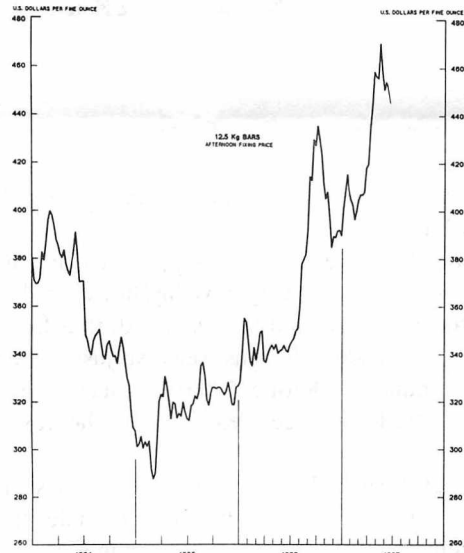


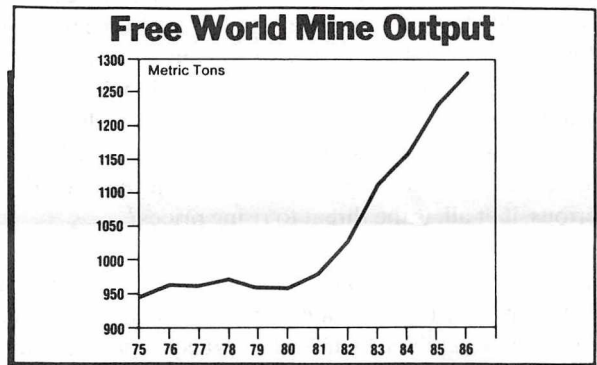
Chart 4

I.M.F. GOLD BULLION AUCTIONS  
(In U.S. Dollars and Cents Per Troy Ounce)

DATE	NOMINAL FINENESS	PRICE	BID RANGE	NUMBER OF OUNCES OFFERED	SOLD	BID FOR AUCTION	TYPE
1976: Jun 2	995+	126.00	126.00@134.00	780,000	780,000	2,368,000	Dutch
Jul 14	995+	122.05	122.05@126.50	780,000	780,000	2,114,000	Dutch
Sep 15	995+	109.40	108.76@114.00	780,000	780,000	3,662,400	Bid Price
Oct 27	995+	117.71	116.80@119.05	780,000	779,200	4,214,000	Bid Price
Dec 8	995+	137.00	137.00@150.00	780,000	780,000	4,307,200	Dutch
1977: Jan 26	995+	133.26	133.26@142.00	780,000	780,000	2,003,200	Dutch
Mar 2	995+	146.51	145.56@148.00	525,000	524,400	1,632,800	Bid Price
Apr 6	995+	149.18	148.55@151.00	525,000	524,800	1,278,000	Bid Price
May 7	995+	148.02	147.33@150.26	525,000	524,800	1,316,400	Bid Price
Jun 1	995+	143.32	143.32@150.00	525,000	524,800	1,014,000	Dutch
Jul 6	995+	140.26	140.26@145.00	525,000	524,800	1,358,400	Dutch
Aug 3	995+	146.26	146.26@150.00	525,000	524,800	1,439,200	Dutch
Sep 7	995+	147.78	147.61@149.65	525,000	524,800	1,084,400	Bid Price
Oct 5	995+	155.14	154.99@157.05	525,000	524,800	971,200	Bid Price
Nov 2	995+	161.86	161.76@163.27	525,000	524,800	1,356,400	Bid Price
Dec 7	995+	160.03	160.03@165.00	525,000	524,800	1,132,600	Dutch
1978: Jan 4	995+	171.26	171.26@180.00	525,000	524,800	984,800	Dutch
Feb 1	995+	175.00	175.00@181.25	525,000	524,800	598,400	Dutch
Mar 1	995+	181.95	181.13@185.76	525,000	524,800	1,418,000	Bid Price
Apr 5	995+	177.92	177.61@180.26	525,000	524,800	1,367,000	Bid Price
May 3	995+	170.40	170.11@171.50	525,000	524,800	3,104,000	Bid Price
Jun 7	995+	183.09	182.86@183.92	470,000	470,000	1,072,400	Bid Price
Jul 5	995+	184.14	183.97@185.01	470,000	470,000	797,200	Bid Price
Aug 2	995+	203.28	203.03@205.11	470,000	470,000	1,467,600	Bid Price
Sep 6	995+	212.50	212.39@213.51	470,000	470,000	772,200	Bid Price
Oct 4	995+	223.68	223.57@224.62	470,000	470,000	805,000	Bid Price
Nov 1	995+	224.02	223.03@230.00	470,000	470,000	889,600	Bid Price
Dec 5	995+	196.06	195.51@196.75	470,000	470,000	1,365,200	Bid Price
1979: Jan 3	995+	219.34	219.13@221.00	470,000	470,000	1,480,000	Bid Price
Feb 7	995+	252.53	252.47@252.77	470,000	470,000	1,489,600	Bid Price
Mar 7	995+	241.68	241.28@243.26	470,000	470,000	1,534,400	Bid Price
Apr 4	995+	239.21	238.71@240.27	470,000	470,000	1,900,000	Bid Price
May 2	995+	246.18	245.86@247.01	470,000	470,000	1,510,000	Bid Price
Jun 1	995+	280.39	280.23@281.37	440,000	440,000	1,450,000	Bid Price
Jul 3	995+	281.52	281.06@281.87	444,000	444,000	1,518,000	Bid Price
Aug 1	995+	289.59	288.95@291.07	444,000	444,000	1,138,800	Bid Price
Sep 5	995+	333.24	332.01@333.50	444,000	444,000	1,650,000	Bid Price
Oct 10	995+	412.78	412.51@420.80	444,000	444,000	665,500	Bid Price
Nov 7	995+	393.55	391.77@398.01	444,000	444,000	1,800,000	Bid Price
Dec 4	995+	426.37	425.40@429.31	444,000	444,000	1,750,000	Bid Price
1980: Jan 2	995+	562.85	561.00@564.01	444,000	444,000	1,340,000	Bid Price
Feb 6	995+	712.12	711.99@718.01	444,000	444,000	1,940,000	Bid Price
Mar 5	995+	641.23	638.16@649.07	444,000	444,000	1,410,000	Bid Price
Apr 2	995+	484.01	480.00@503.51	444,000	444,000	802,800	Bid Price
May 7	995+	504.90	500.20@511.15	444,000	443,200	1,820,000	Bid Price

\*May 7th auction completed monthly four year sales program started in June 1976.

Chart 3



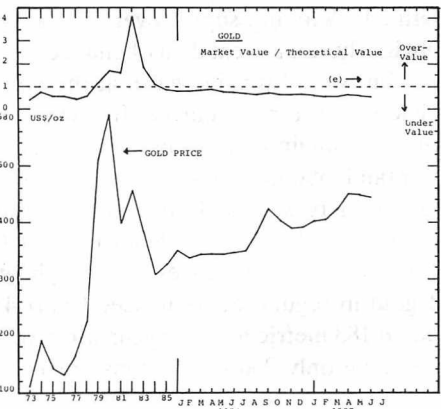
BARRON'S

Chart 5

U.S. GOLD BULLION AUCTIONS  
(In U.S. Dollars and Cents per Troy Ounce)

DATE	NOMINAL FINENESS	PRICE	BID RANGE	NUMBER OF OUNCES OFFERED	SOLD	BID FOR AUCTION	TYPE
1975: Jan 5	999.5+	165.67	161.00@188.00	2 mn	956,000	less than 1/2 Dutch	
Jun 30	999.5+	165.05	32.50@182.00	500,000	449,500	4,160,000	Dutch
1978: May 23	999.5+	180.38	180.01@182.35	300,000	300,000	1,350,000	Bid Price
Jun 20	999.5+	186.91	186.52@190.29	300,000	300,000	1,040,000	Bid Price
Jul 18	999.5+	185.16	185.05@189.00	300,000	300,000	1,386,000	Bid Price
Aug 15	999.5+	213.53	213.23@216.17	300,000	300,000	564,400	Bid Price
Sep 19	999.5+	212.76	212.56@213.21	300,000	300,000	800,000	Bid Price
Oct 17	999.5+	228.39	228.16@229.25	300,000	300,000	818,000	Bid Price
Nov 21	999.5+	199.05	197.00@201.30	750,000	750,000	911,600	Bid Price
Dec 19	999.5+	214.17	211.50@217.50	1,500,000	1,500,000	2,717,200	Bid Price
1979: Jan 16	995+	219.71	219.23@222.00	1,000,000	1,000,000	5,500,000	Bid Price
Feb 22	995+	218.22	217.51@220.93	500,100	500,100	1,300,000	Bid Price
Mar 20	995+	252.38	251.76@254.16	1,000,000	1,000,000	2,000,000	Bid Price
Apr 17	900+	240.09	238.74@242.03	500,100	500,100	800,000	Bid Price
May 15	900+	230.96	230.13@232.10	1,000,000	1,000,000	2,300,000	Bid Price
Jun 19	900+	230.17	229.21@231.53	500,100	500,100	1,100,000	Bid Price
Jul 17	900+	254.92	254.62@255.47	750,000	750,000	2,400,000	Bid Price
Aug 19	900+	279.02	278.13@280.31	750,000	750,000	2,000,000	Bid Price
Sep 17	900+	296.44	295.11@296.76	750,000	750,000	2,100,000	Bid Price
Oct 21	900+	301.08	300.88@301.50	750,000	750,000	2,300,000	Bid Price
Nov 18	900+	377.78	310.00@379.00	750,000	750,000	2,500,000	Bid Price
Dec 16	900+	391.98	390.16@398.07	750,000	750,000	2,000,000	Bid Price
Nov 1	900+	372.30	320.00@378.12	1,250,000	1,250,000	1,500,000	Bid Price

Chart 6



# Silver and platinum

Last month we opined that a break below 7.50/oz. for silver would confirm the suspicion that prices had merely been "put up," lacking a genuine shift to more positive underlying fundamentals. Recent action, a 41% drop from the \$11/oz. highs recorded in April, while gold managed to "correct" a mere 9% in the same span of time, supports this view.

Until there is more evidence of a steady and growing demand for silver (even if only for investment purposes), we prefer the safety and certainty of gold.

Platinum, on the other hand, has been enjoying growing

popularity, making the demand far more dependable (see last month's *FC&CC*). As a result, not only has the correction been more orderly and moderate than in silver, but its basic uptrend has persisted: Nearby platinum prices have corrected approximately 50% of the November/December '86 to April '87 rise, a relatively "normal" occurrence.

**STRATEGY:** *Stand aside but keep posted for a reentry recommendation.*

Chart 7 — COMEX SILVER JULY 87

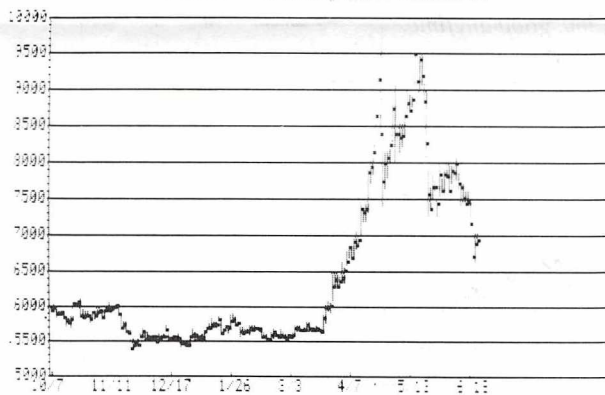
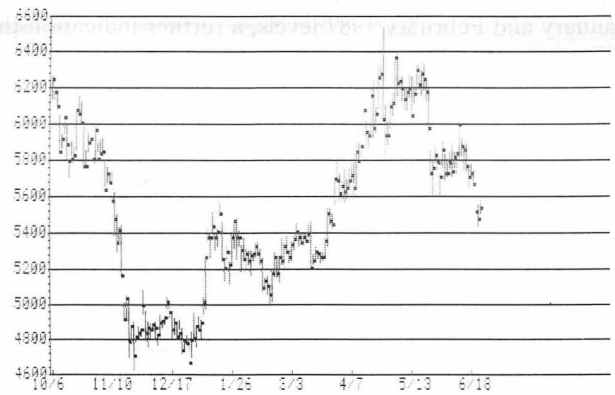


Chart 8 — NYME PLATINUM JULY 87



# Interest Rate Futures

A slightly stronger dollar, a 5% drop in the widely-watched CRB index (see Chart 9), and a deeply oversold condition made for a good-sized rally that saw prices recover almost 50% of their previous drop.

The market is marking time in an otherwise fated outcome: Interest rates have begun a long upward journey that will, ultimately, test the 1981-82 level.

**STRATEGY:** *We were stopped out of a very profitable short position when September '87 closed above 91.16 (as per last month's suggestion). When and how do we reenter the short side? Follow the short-term uptrend from the May lows (see Chart 10) and sell any downward penetration of this uptrend, on close only. Our views on the yield curve (that it will remain quite positive and perhaps even steepen) make us favor the short side of T-bonds over the short side of Eurodollars. However, chaqun à son goût.*

Chart 9 — NYFE CRB PR. IND CASH

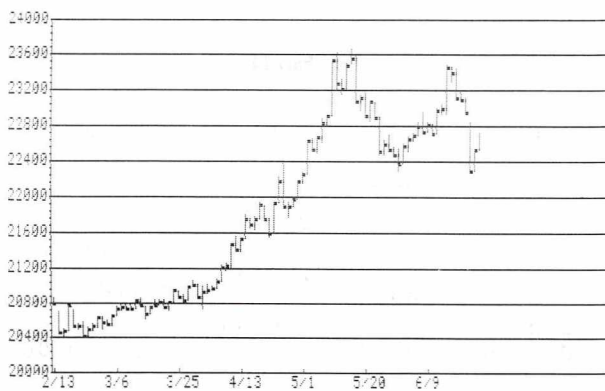
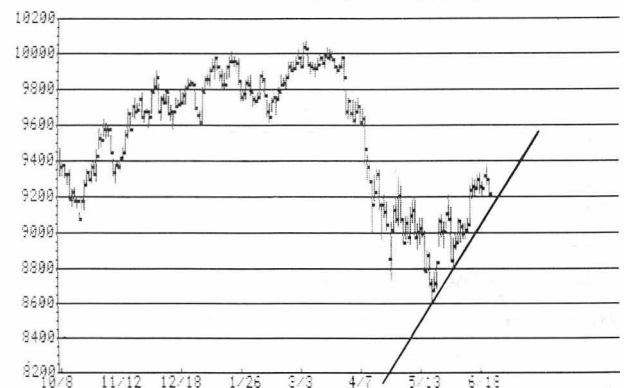


Chart 10 — CBT U.S. T-BONDS SEP 87



# Stock Indexes

The least insightful comment one can make about the US stock market is its remarkable lack of breadth as it continues to make new all-time highs. And yet, this feature has been *the* salient feature of this bull market since mid-1983. The most persistent and glaring indicator has been the Value Line/S&P ratio, having just recorded a new, four-year low (.876 from a high of 1.33; see Chart 11 for a picture since January 1986).

A second, no less important, indicator is the new highs minus new lows differential (see Chart 12). It peaked in February 1986, with the Dow Jones 30% lower than it is today! The most recent advance to new highs in both the Dow Jones and the S&P 500, left the high-low index pitifully short of the January and February 1987 levels, a further indication that

the market is losing momentum. Lastly, the A/D, line the cumulative differential between the *weekly* (not daily) advances and declines, which has, to date, confirmed all the major thrusts to new highs since the bull market began in 1982, has finally produced a non-confirmation as it failed to make new highs in the most recent stretch.

While cyclical companies and commodity producers remain strong, it is unlikely that these groups will be able to sustain the overall market. Once again, we believe the odds are with the bear.

**STRATEGY:** Sell September '87 S&P at market, risking 31360, good anytime.

Chart 11 - VL. C/INX87



Chart 12

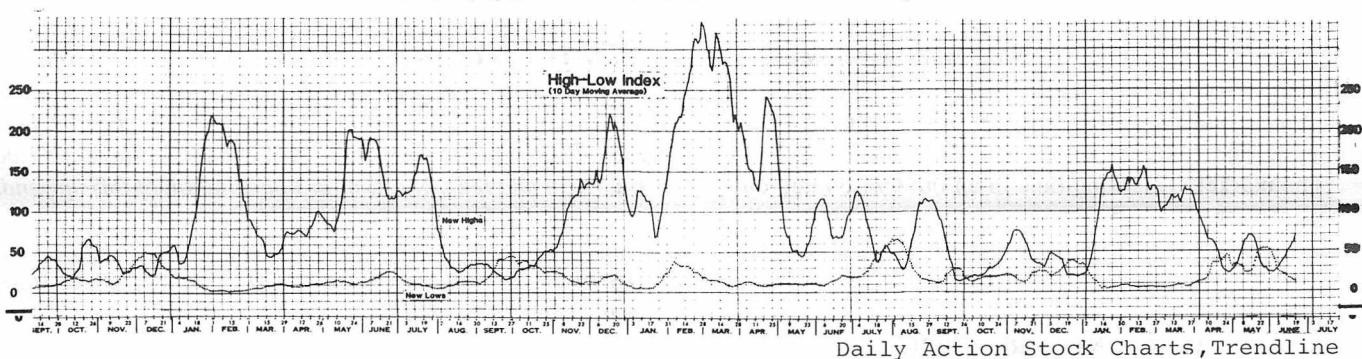
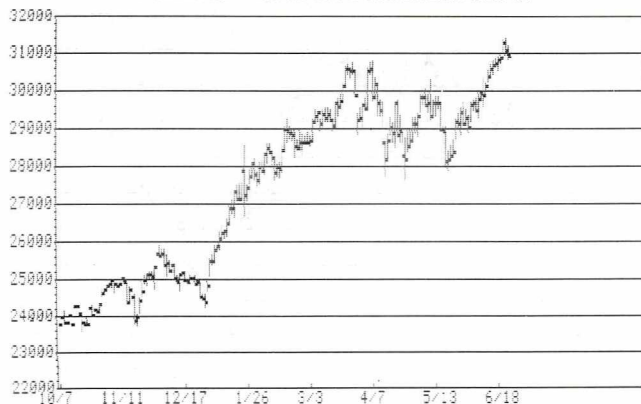


Chart 13 - CME 500 STK. INDX. SEP 87



Daily Action Stock Charts, Trendline

S&P	Chart 14		
Date	Bot	Sold	Realized P/L
May 12		294.45	
May 26	288.20		+ 3,125.00
May 27		290.00	- 1,250.00
May 28	292.50		
Jun 9		296.00	
Jun 10	298.00		- 1,000.00
	Total		+ 875.00

# Price expectations, inventories and copper

In the last issue of *Friedberg's Commodity & Currency Comments* (May 24, 1987), we stated that "inventory cycles are the single most potent cause of fluctuations in internationally-traded primary commodity prices." We continue to pursue our inventory analytics.

Manufacturers and dealers adjust their inventory levels to the point where the extra revenue from holding stocks equals the extra cost of holding stocks. Chart 15 provides a picture of the so-called "supply of storage," and will be used to assist in explaining inventory adjustments.

Let's start with a situation in which raw material prices are expected to decline (OA on Chart 15). In this case, desired inventories are low (OB on Chart 15), since inventories wouldn't be held for speculative purposes but only for the purpose of avoiding the costs of hand-to-mouth materials procurement. This roughly reflects the situation that existed in many commodity markets until rather recently.

At present, however, price expectations in many markets have changed. Manufacturers and dealers have begun to expect prices to increase (OC on Chart 15). These changed price expectations have caused disproportionate increases in desired inventory levels (OD on Chart 15).

It is with these changes in the price expectations and desired inventory levels that the price dynamics begin to work in a potentially explosive manner. In the short term, consumption and production can't change too much. Also, inventories, on a global basis, can't change. However, the desired

level of inventories has increased disproportionately. Something must give, and it is price. As merchants and dealers bid inventories away from one another, in an attempt to push actual inventories toward desired levels, prices strengthen and can explode in a self-feeding manner.

These price increases eventually send their signals and break the impasse. Higher prices reduce consumption, which allows for inventory building. They also cause marginal production to come into the market, which allows for inventory building. However, this process can take a considerable amount of time, depending on how long it takes for consumption and production to react to higher prices. Needless to say, the longer the adjustment process, the larger the potential price run ups.

**STRATEGY:** *Copper consumption has outpaced production since 1984. In consequence, inventories have fallen to 641,000 tonnes, which is their lowest level since 1974 (Chart 16). This is equivalent to only 4.5 weeks of consumption, which is well below the 1983 level of 12.5 weeks and also below what many believe the desired level of stocks to be (7-8 weeks). With these inventory fundamentals, spot prices running at three-year highs and market backwardation, copper is in a bull market. Technical analysis also confirms this conclusion, since the price strength generated in the copper market has come when the market usually begins its June-July sluggishness. Buy September '87 copper; place initial stops at 66.00, close only.*

— By Steve H. Hanke

Chart 15 — Desired Inventory Levels

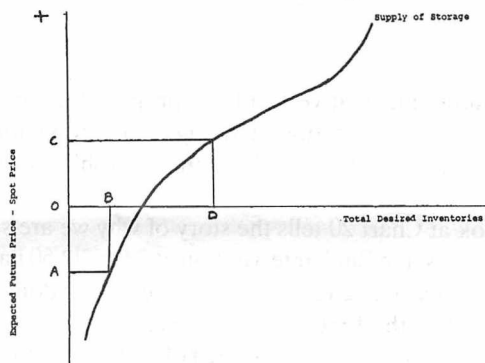


Chart 17 — COMEX COPPER SEP 87

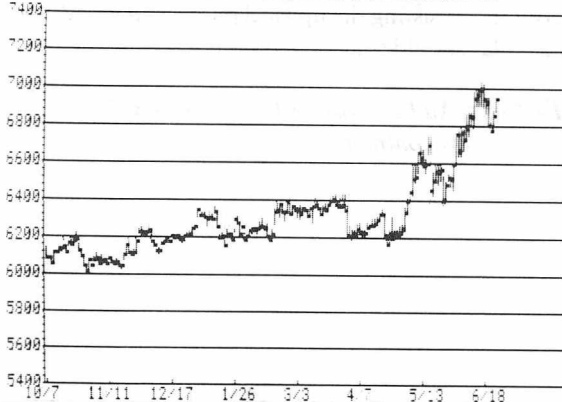


Chart 16  
Copper: Producer - Consumer Stocks and Prices  
(in 000's)

	Worldwide Refined Stocks (Thousand Tonnes — End of Period)					CMX, Spot				
	LME	CMX	U.S.	RoW	Merch	U.S.	Others	Total	(Chg)	¢/lbs
1983	436	317	60	328	147	150	176	1667	(+27)	
1984	126	151	175	259	27	164	189	1191	(-476)	
1985	190	109	136	266	31	122	180	1034	(-156)	63.2
Mar 86	153	106	114	242	39	116	149	923	(-111)	66.0
Apr 6	133	104	106	251	39	111	150	894	(- 29)	63.8
May	134	98	84	246	39	117	151	869	(- 25)	62.7
Jun	143	94	77	217	37	106	155	829	(- 40)	62.6
Jul	155	87	103	232	32	128	152	889	(+ 60)	58.9
Aug	157	82	112	256	27	123	160	917	(+ 28)	57.6
Sep	162	79	92	249	22	100	156	860	(- 57)	60.7
Oct	173	73	98	247	23	91	143	851	(- 9)	59.2
Nov	176	76	115	248	24	80	130	849	(- 2)	58.9
Dec 86	175	86	132	251	25	84	116	869	(+ 20)	60.2
									(-165)	
Jan 87	175	93	98	250	28	66	112	822	(- 47)	60.8
Feb	140	98	89	233	—	56	104	748	(- 74)	61.7
Mar	124	94	66	214	—	51	99	676	(- 72)	63.6
Apr	145	79	79	—	—	48	—	692	(+ 16)	62.4
May	110	63	—	—	—	—	—	641	(- 51)	
									(-228)	

Source: Drexel Burnham Lambert

# CRB Index

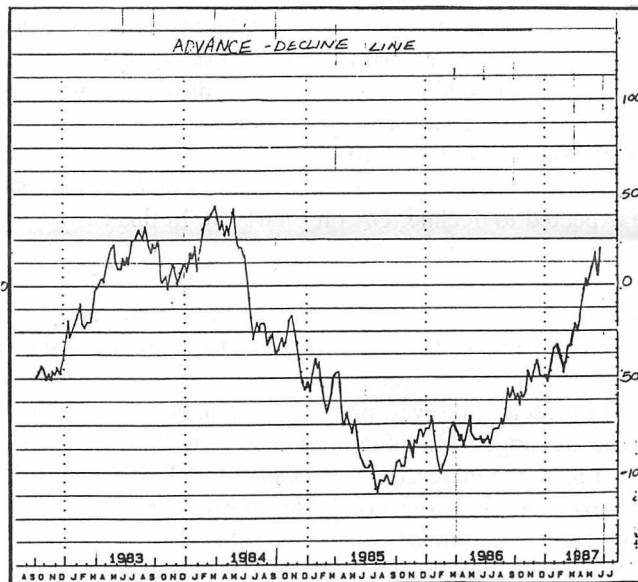
In stark contrast to its first cousin, the S&P 500, the CRB index continues to display impressive breadth (see Chart 18) and remains a very favorable omen for rising prices.

**STRATEGY:** *Remain long.*

Chart 18



Chart 19



# Currencies

## Canadian dollar

**STRATEGY:** *Stopped out as advised to cover on close above 74.85, basis September '87. Remain sidelined.*

## Australian dollar

An extraordinary opportunity to play against the House with the odds stacked in your favor.

Australia's terms of trade have been improving mightily as commodity prices recover. Fiscal behavior is on the mend and monetary policy continues to encourage positive interest rates. And while the Labour party is a clear favorite to win the September national election, opposition parties have

become quite imaginative and have proposed dramatic tax reductions and privatizations, making for a very palatable alternative. Clearly, the *political spectrum* has shifted dramatically to the right.

A look at Chart 20 tells the story of why we are so bullish: Heavy Reserve Bank intervention at 72.25-72.50 has been resisting the *inevitable* revaluation of the Aussie dollar. During April, after the first bout of intervention, international reserves rose to a new four-year high of US\$8.4 billion. In the interest of a firm monetary policy, the Reserve Bank is not likely to continue resisting the upward push. As it withdraws, the Aussie dollar should soar *well beyond 75¢*.

**STRATEGY:** *Add to existing long positions, buying the September '87 IMM contract.*

Chart 20 — MIDLAND BANK AUD CASH

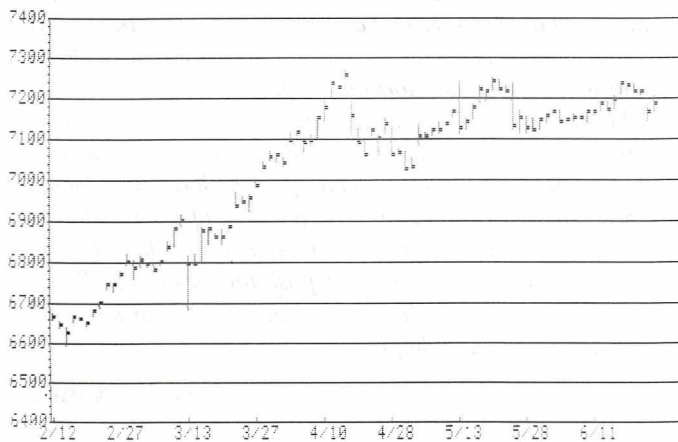
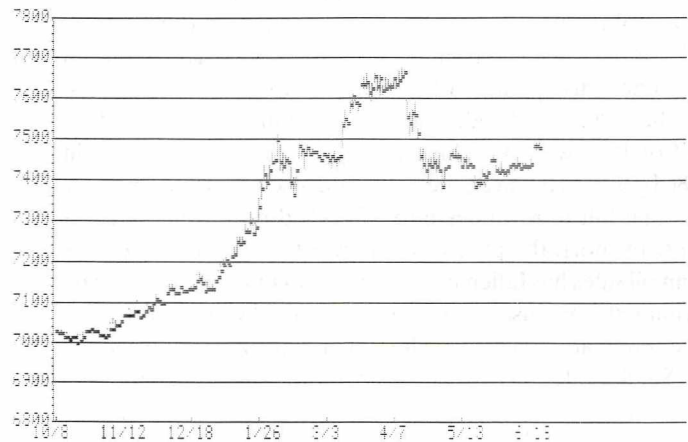


Chart 22 — CME CAN. DOLLARS SEP 87



## The Saudi squeeze

In November 1986 we stated that "The strategy of posting an Opec oil price of \$18 per barrel would cost the Saudis dearly." (See: *FC&CC*, Nov. 16, 1986). Since then, Opec has agreed on an output quota (15.8 million barrels per day (b/d) and posted a price (\$18 per barrel). In consequence and in accordance with our analysis, the Saudis have been squeezed.

### The leverage squeeze

One squeeze on the Saudis results because they tend to operate as a residual or swing producer. Hence, any changes in the demand for oil have a magnified effect on the Saudis' production. For example, the Saudis have about a 25% share of Opec production, and Opec has about a 40% share of the non-communist production. Hence, if non-Opec production changes by 1% of the total market production or the total market demand for oil changes by 1%, then the Saudis must alter their production by 10%, if they wish to maintain a target price (see *FC&CC*, May 24, 1987).

As the supply of non-Opec oil increased and the total world demand for oil decreased in the 1980-85 period, Saudi oil exports were squeezed by leverage, and collapsed from over 9 million b/d to little more than 2 million b/d. In consequence, Saudi oil revenues plunged from \$113 to \$76 to \$48 to \$44 to \$34 billion in 1981, 1982, 1983, 1984 and 1985, respectively. Oil revenues in 1986, the year the Saudis attempted to regain some of their market share, fell to about \$17 billion. In the first half of 1987, which represents the first six months in which the new Opec agreement was in force, Saudi oil revenues are estimated at \$8.7 billion. When compared with the first half of 1986, this represents a 9.5% revenue decline. This decline is the result of the fact that under the new agreement, the Saudis, in their role as a swing producer, have had to produce at below their assigned Opec quota (4.1 million b/d) to prop up the price of oil.

Whether the Saudis continue to play the role of a swing producer and keep the oil price propped up will be deter-

mined, in part, by the level and trend in the demand for Opec oil and the extent to which the smaller Opec producers share the burden of any market weakness. The stronger the market, the easier it will be for the Saudis to overlook cheating. The weaker the market, the more difficult.

Let's first look at the world demand for oil, so that we can gauge the Saudis tolerance for cheating. In 1986, the demand increased by 2.2%. The International Energy Agency thought that growth would fall to only 1% in 1987. However, this forecast continues to be revised downward because the economic growth forecasts for the 24 nations that belong to the Organization for Economic Cooperation and Development (OECD) continue to be revised downward. For example, 1987 real growth in the OECD countries is now projected at 2.25%. This is down from the 2.75% forecast, which was made in January.

The world demand for oil appears to be on the weak side. This, coupled with stable or perhaps modest increases in non-Opec production, means that the demand for Opec oil will be on the weak side. In consequence, the Saudis will not be in a mood to tolerate too much cheating within Opec because it will squeeze the Kingdom's residual production too hard.

This leads us to the following question: What are the prospects for cheating within Opec? At present, a good bit of cheating is occurring. The Opec ceiling is 15.8 million b/d, and recently production has edged up to 17 million b/d. This "overage" will continue, if not increase, regardless of whether the market is weak or strong, since a weak market creates the financial imperative to cheat, and a strong market creates an environment in which producers believe they can get away with cheating.

### The dollar squeeze

If the leverage squeeze and its consequences for Saudi oil production and nominal oil revenues were not enough, the

Saudis have found themselves being squeezed by the falling value of the dollar. Remember that oil is priced in dollars. Hence, if the nominal price of oil is constant but the dollar's value is falling, the real value of revenues per barrel of oil will fall. The consequences of the dollar's drop can be observed in Chart 26. The Saudis' nominal revenues during the first half of 1987 were \$8.7 billion, down on the same period in 1986 by 9.5%. However, the dollar squeeze translated this 9.5% nominal fall in revenues into a 28.1% drop in real oil revenues. In short, the purchasing power that the Saudis derive from oil sales has fallen much more than that which would be estimated from just looking at the nominal value of oil sales. The implication is clear: The dollar squeeze acts to reduce the Saudis' tolerance for cheating by other members of Opec.

It is worth mentioning that for Opec as a whole, nominal oil revenues in the first half of 1987 were \$39 billion, up 5% on the same period in 1986. However, when adjusted for the falling value of the dollar, this positive 5% becomes a negative 11.2%. The implication is clear: Opec's purchasing power from oil sales is falling, which increases the financial imperative for members to cheat on Opec quotas.

**Prospects for price stability**

For price stability to hold, the following conditions must occur:

- (1) The demand for world and Opec oil must not show any further signs of weakness, which means that economic growth in the OECD countries must not deteriorate and severe oil inventory draw downs must not occur. If inventory draw downs and/or economic weakness reduce demand for Opec oil, the Saudis, faced with the leverage squeeze, would find their production dwindling to nothing, or to the level of Saudi consumption plus existing barter deals, which is probably the closest thing to a Saudi production floor. At that time, the Saudis will have to resort to a price war in order to survive.
- (2) The Saudis must continue to act as a swing producer, which means that the other Opec members must not cheat too much on their quotas. If cheating continues, the leverage squeeze will force the Saudis to engage in a price war in order to force other Opec members to behave.

**STRATEGY:**

**Oil** — *We remain on the sidelines in the oil market. We prefer to wait until the leverage and dollar squeezes force the Saudis to display some clearer signs as to their displeasure with cheating before we enter the short side of this market.*

**Saudi riyal** — *We remain short. The Saudis' oil revenues, measured in dollars, continue to fall on both a nominal and real basis. Moreover, the Saudi budget, which is denominated in riyals, continues to generate large amounts of red ink. Hence, a devaluation, which will generate more riyals per barrel of oil, is expected. Note that new short positions in the Saudi currency can be carried at less cost because the riyal has gone from a discount to a slight premium.*

— By Steve H. Hanke

Chart 26  
Opec's Oil — Export Revenues

Country	Revenues, First' Half 1987, \$ billion Est.	Real % Change <sup>2</sup> on First Half 1986
Saudia Arabia	8.7	-28.1
Iran	4.5	+12.0
Iraq	4.9	+21.7
Kuwait	2.5	-21.4
UAE	3.3	-9.7
Qatar	0.7	-29.4
Venezuela	3.8	-3.0
Nigeria	3.4	-18.9
Indonesia	2.4	-8.3
Libya	2.6	-5.9
Algeria	1.5	nil
Gabon	0.4	-2.8
Ecuador	0.3	-60.7
Total	39.0	-11.2

Notes: 1. Excludes Neutral Zone.  
2. Adjusted for decline in dollar trade-weighted index.  
3. Source: the Petroleum Finance Company.

# Friedberg Capital Markets

The floating rate note (FRN) market has experienced phenomenal growth over the past seven years. Until 1980, only \$10 billion FRNs had been outstanding. From 1980-85 the FRN market grew to over \$100 billion out of a total US \$140 billion Eurobond market. In September 1985 a US \$2.5 billion FRN issue was launched by the United Kingdom. This single issue broke all records, and is referred to by market-makers as a benchmark issue. Since then, growth in FRNs has accelerated to reach over \$293 billion.

A phenomenon that has developed in the Eurobond market is that the less frequently traded bonds become even more infrequently traded and spreads between the bids and offers

widen. Conversely the more actively traded bonds become extremely liquid and are characterized by narrow spreads, meaning that there is a marked concentration of liquidity, rather than an overall liquidity problem. The United Kingdom floater is traded so actively that the bid-offer spread is consistently one of the narrowest in the entire Eurobond market.

The coupon on the UK '92 FRN is three-month LIBID (approximately 1/8-1/4 below LIBOR). The FRN pays interest and resets quarterly so that the coupon resembles a 90-day term deposit in US dollars.

If the prudent investor were to do an exercise in comparison shopping for the best rate on 90-day US dollars, he would

discover the results shown in Chart 27.

Value-oriented buyers should note that US dollar deposits are not insured by Canadian chartered banks. The UK floater, on the other hand, is backed by the full "faith and credit of the Government of the United Kingdom," and is rated AAA by S&P's rating service.

Chart 27

BANK	S&P's Rating	US\$ Rate ( 90 days)
Cdn. Imp. Bank of Commerce	AA	* 6.1275%
Bank of Montreal	AA	* 6.125%
Royal Bank of Canada	AA-	* 6.125%

\* Term deposit rates in Toronto, as of June 18/87

ISSUER	S&P's Rating	US\$ rate for next (90 days)
UNITED KINGDOM	AAA	** 7.0625%

\*\* Based on current coupon and June 18/87 LIBID rate.

Friedberg Capital Markets is making available: United Kingdom quarterly (3-month LIBID) floating rate notes due 7/10/92, which offer investors a unique opportunity to park US funds in a highly liquid floating rate instrument of supreme quality.

Chart 28

Foreign Currency Bonds

DATE: June 24, 1987

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

ISSUER	MTY. DATE/COUPON	BID	OFFER	CURRENT ANNUAL YIELD TO MTY.	LAST PAY DATE	NEXT PAY DATE
<b>NEW ZEALAND DOLLAR DENOMINATED BONDS</b>						
COCA COLA	16/6/89 18%	102	- 102 3/4	16.22	16/6/87	-16/6/88
HONDA INT'L	20/9/89 3/8%	97 1/2	- 98 1/2	17.06	20/6/86	-20/9/87
HONDA INT'L	28/5/90 16%	97	- 97 3/4	16.63	28/11/86	-28/5/88
TOURIST HOTEL CORP. (N.Z.)	4/6/95 zero coupon	44 1/2	- 45	14.42	matures 4/6/93	
BANK OF NOVA SCOTIA	15/9/89 18% RRSP eligible	101 1/2	- 102 1/2	16.85	15/5/86	-15/9/87
WELLS FARGO ( semi-ann.)	12/5/89 16 1/8%	97 3/8	- 98 1/8	18.05	12/5/87	-12/11/87
KODAK (semi-ann.)	15/2/89 17%	101	- 101 3/4	16.31	12/2/87	-15/8/87
TORONTO DOMINION	2/4/90 18% RRSP eligible	101 1/2	- 102	16.91	2/4/87	- 2/4/88
<b>AUSTRALIAN DOLLAR DENOMINATED BONDS</b>						
CAN. IMP. BANK OF COMMERCE	13/3/91 13% RRSP eligible	98	- 98 3/4	13.39	13/3/87	-13/3/88
<b>DEUTSCHE MARK DENOMINATED BONDS</b>						
REPUBLIC OF PORTUGAL	19/6/94 6 5/8%	102	- 102 3/4	6.13	19/6/87	- 19/6/88
GOVT. OF BELGIUM	29/4/96 5%	94 1/2	- 95	6.25	29/4/87	- 29/4/88
QUEBEC HYDRO	1/5/96 5% RRSP eligible	95 3/8	- 96 1/8	6.08	1/5/87	- 1/5/88
<b>SWISS FRANC DENOMINATED BONDS</b>						
GOVT. OF AUSTRALIA	30/10/98 5%	101 7/8	- 102 5/8	4.69	30/10/86	-30/10/87
<b>JAPANESE YEN DENOMINATED BONDS</b>						
GOVT. OF CANADA	23/7/93 5 5/8% RRSP eligible	101 3/4	- 102 1/2	5.18	23/7/86	-23/7/87
<b>U.S. DOLLAR DENOMINATED FLOATING RATE NOTES</b>						
ISSUER	MAT. DATE	COUPON	BID	OFFER	CURRENT COUPON	NEXT COUPON DATE
SANTA BARBARA SAVINGS & LOAN (fully collateralized)	18/12/95	pays 1/8% over 3 month LIBOR (quarterly)	99.70	- 100	7 5/16%	18/9/87
LINFIN SAVINGS & LOAN (fully collateralized)	14/11/95	pays 1/8% over 3 month LIBOR (quarterly)	99.60	-	7 3/8%	18/8/87
UNITED KINGDOM	7/10/92	3 month LIBID (quarterly)	99.91-100.11	-	6 9/16%	7/7/87

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

# The Exotics

## Venezuelan bolivar

As we've pointed out many times in the past, Venezuela is a prime example of what incompetent management can do in a resource-rich country. A serious but certainly not catastrophic overvaluation in the early 1980s led to a series of foreign exchange measures that sank the country into a deeper and deeper quagmire. A unified foreign exchange market either under a clean-floating regime or a fixed-rate regime would have solved the bolivar's overvaluation; would have stopped the continued hemorrhage of capital out of the country, would have allowed the country to adjust to its falling oil revenues by making nontraditional exports more competitive, and would have balanced the fiscal books.

Instead a crazy multi-layered exchange regime with widely different rates for various economic activities failed to clear the market, emitted a signal of mishandling and ineptitude,

encouraged corruption in its administration, fostered capital flight and speculative round-tripping, and punished nontraditional exporters.

Furthermore, monetary, debt, and fiscal policies became subservient to this insane regime and ended up ratcheting up inflation in this country, which once possessed the best record of price stability in Latin America.

As the problems mount, the government continues to get itself deeper into problems; a compensatory bonus of 25% is mandated for wages to make up for the drop in living standards, coupled with a 120-day price and firings freeze. Business confidence and investment are likely to collapse, and of course, little headway will be made in the anti-inflation effort. At the same time, the central bank's international reserves have been bleeding severely in an effort to maintain unrealistic exchange rates, primarily the 7.5 and 14.5 bolivares to the dollar.

Since the end of 1985, reserves have dropped to US \$6 billion (as of April 1987) from US \$10.2 billion. The government is financing a huge flight of capital at a time when it needs every cent to amortize and service its huge foreign debt. The free market, sensing disaster, has already marked down the rate to 30 bolivars to the dollar. In response, and quite predictably, the government has gone on a rampage against private foreign exchange operators, closing them down in order to "minimize speculations in the free market which go against the bolivar and affect agents who carry out legitimate transactions in the same market." A case of stupidity breeding stupidity.

As long as these policies are in place, there is little use in forecasting current account balances. While 1987 may see a recovery in the current account, from a deficit of US \$1.6 billion in 1987 to possibly a surplus of US \$100 million in 1987, continuous capital flight will dominate the exchange outlook and the solvency question.

**STRATEGY:** *It is clearly not prudent to take position in a market that is subject to so much manipulation or rigging. Commercial operators should try to make a major effort to hedge their bolivar exposure.*

Chart 29

YEAR	VENEZUELAN BOLIVARES PER	U.S.	U.S.
	U.S. DOLLAR (PERIOD)	1970=1.00	1978=1.00
1967	4.45	0.9152	0.9239
1968	4.45	0.9423	0.9514
1969	4.45	0.9684	0.9779
1970	4.45	1.0000	1.0096
1971	4.44	1.0101	1.0198
1972	4.40	1.0057	1.0153
1973	4.30	1.0016	1.0113
1974	4.28	1.0215	1.0313
1975	4.28	1.0132	1.0229
1976	4.28	0.9972	1.0067
1977	4.29	0.9851	0.9945
1978	4.29	0.9905	1.0000
1979	4.29	0.9800	0.9894
1980	4.29	0.9155	0.9242
1981	4.29	0.8713	0.8796
1982	4.29	0.8421	0.8502
1983	9.90	1.8866	1.9048
1984	12.65	2.2411	2.2626
1985	14.40	2.3700	2.3928
1986 (1Q)	18.85	2.9338	2.9619
1986 (2Q)	16.95	2.5964	2.6213
1986 (3Q)	20.41	3.0490	3.0783
1986 (4Q)	22.70	3.2731	3.3045

Above 1.00 = undervalued  
Under 1.00 = overvalued

Chart 30

Year	Foreign Assets (Min US\$)	CURRENT ACCOUNT	CUMULATIVE 12 QTR.
		As % of GNP	Current Account (Min US\$)
1970	899	-0.09	-518
1971	1,389	0.00	-335
1972	1,612	-0.07	-216
1973	2,387	5.34	756
1974	6,413	22.53	6536
1975	8,807	7.85	8808
1976	7,961	0.08	8185
1977	8,081	-8.78	-754
1978	6,701	-14.61	-8660
1979	8,124	0.07	-8564
1980	7,383	7.94	-657
1981	8,870	5.97	9078
1982	9,708	-6.40	4482
1983	5,163	15.60	4473
1984	6,116	20.21	5599
1985	6,229	12.43	12931
1986	2,873	-	6404

Chart 31

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

Reserves \* + Previous 12-months curren Account \*\*\*= 5935  
 (Reserves + 12-months C/A) / M1 \*\* = 5935/4338 = 136 %  
 (Reserves + 12-months C/A) / Broad Money \*\* = 5935/9599 = 62%  
 \*As at April 1987 \*\* Dec. 1986 \*\*\* 1986

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Figures in millions of U.S. Dollars

	M1 (Converted to U.S. Dollars)	Broad Money (Converted to U.S. Dollars)
1977	7927	14329
1986 (Dec.)	4338	9599
% Increase (decrease)	(45.3)	(33.0)
Corresponding % increase in the United States	108.2%	132.5

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(a) 1985 Imports as percentage of GNP 29.77  
 (b) 1976 - 1985 Imports as percentage of GNP 22.45  
 1985 /1976 - 1985 average = (a)/(b) = 132.60

Source: IFS

Chart 32 - Rates

SPOT	1 MONTH	3 MONTH	6 MONTH	12 MONTH
28.95 -	29.15 -	29.65-	29.90 -	30.45-
29.05	29.40	29.95	30.50	31.95

# Portuguese escudo

Portugal has made very little progress over the past few years in correcting some of its most urgent structural problems. State-owned enterprises remain highly inefficient and continue to accumulate deficits, thus making the job of slimming down the public sector nearly impossible. The fragile minority centre-right government, led by Mr. Anibal Cavaco Silva, recently unveiled a blueprint for economic modernization, focusing on creating more jobs and reducing unemployment (currently standing at 9.6% of the work force). Furthermore, the government would like to reduce the budget deficit to around 5% of GDP by 1990 from the 1986 level of nearly 11%. The two major impediments to the realization of this goal are the debt ridden state corporations, as mentioned, and the strong political opposition to the plan by the left-wing opposition parties who actually hold a majority in parliament.

In the meantime, Portugal is riding the wave of some favorable short-term economic developments. The drop in world interest rates, the weaker dollar, and cheaper oil and

raw material prices helped Portugal achieve a current account surplus of US \$1.13 billion in 1986. The bulk of the improvement seems to have taken place already, and the current account surplus is forecast to narrow to US \$400 million in 1987. The escudo's real rate of exchange on a trade-weighted basis has appreciated by almost 14% since 1983, the last major trough in the real level of the exchange rate for the past 20 years.

Without basic structural changes, Portugal is unlikely to make major progress in reducing its foreign debt levels and consequently its vulnerability to external shocks in the years ahead. This is true despite Portugal's year-old membership in the European Common Market and its beneficial effect on competitiveness.

**STRATEGY:** In the near to medium term, the Portuguese escudo is likely to remain relatively firm on a trade-weighted basis, especially when due account is made for the forward discount. Aggressive traders may want to purchase six-month forward escudos against the sale of US dollars. Remain neutral, however, against the DM.

Chart 33

YEAR	PORTUGUESE ESCUDO PER U.S. DOLLAR (PERIOD )	U.S.		BASKET	
		1972 =1.00	1979=1.00	1972 =1.00	1979 =1.00
1967	28.8420	1.1814	1.4607	1.1424	1.1413
1968	28.7280	1.1604	1.4348	1.0478	1.0468
1969	28.5620	1.1292	1.3962	1.0158	1.0148
1970	28.6260	1.1472	1.4184	1.0382	1.0372
1971	28.1920	1.0965	1.3558	1.0360	1.0356
1972	27.0530	1.0000	1.2365	1.0000	0.9991
1973	24.5150	0.8709	1.0768	0.9150	0.9141
1974	25.4080	0.7831	0.9683	0.8193	0.8186
1975	25.5530	0.7136	0.8824	0.7863	0.7856
1976	30.2290	0.7548	0.9333	0.7815	0.7807
1977	38.2770	0.8018	0.9914	0.8606	0.8598
1978	43.9370	0.8063	0.9970	0.9336	0.9327
1979	48.9230	0.8088	1.000	1.0009	1.0000
1980	50.0620	0.8050	0.9954	1.0512	1.0502
1981	61.5460	0.9105	1.1258	1.0464	1.0454
1982	79.4730	1.0160	1.2562	1.0718	1.0708
1983	110.7800	1.1686	1.4450	1.1379	1.1368
1984	146.3900	1.2494	1.5448	1.1158	1.1147
1985	170.3900	1.2582	1.5557	1.1111	1.1100
1986	149.5900	1.0081	1.2465	1.0161	1.0152
1987 (1Q)	141.6600	0.9119	1.1275	0.9804	0.9795

Above 1.00 = undervalued  
Below 1.00 = overvalued

Chart 34

Year	Foreign Assets (Min US\$)	CURRENT ACCOUNT		CUMULATIVE 12 QTR. Current Account (Min US\$)
		As % of GDP	%	
1970	1,730	-	-	-
1971	2,119	-	-	-
1972	2,540	4.13	-	-
1973	2,937	2.96	-	-
1974	2,520	-6.17	-1.35	-1.35
1975	1,412	-5.13	-6.17	-7.52
1976	285	-8.36	-2.867	-10.387
1977	-1,426	-5.83	-2.994	-13.381
1978	-1,177	-2.65	-2.702	-16.083
1979	-854	-0.27	-1.474	-17.557
1980	3,065	4.35	-1,581	-19.138
1981	1,772	-10.90	-3,723	-22.861
1982	1,657	-13.90	-6,919	-29.780
1983	1,411	-4.90	-6,859	-36.639
1984	1,717	-2.70	-4,768	-41.407
1985	-	+1.90	-1,108	-42.515
1986	-	+5.20	+1,026	-41.489

Chart 36 - Rates

SPOT	1 MONTH	3 MONTH	6 MONTH	12 MONTH
142.10-	142.60 -	1.4460 -	147.10-	149.60-
142.60	144.10	1.7410	150.60	160.10

Chart 35

HARD CURRENCY COVER ( In millions of U.S. Dollars)		
Reserves * + Previous 12-months current Account ***	10370	
(Reserves + 12-months C/A) / MI **	10370/9166 = 113.1%	
(Reserves + 12-months C/A) / Broad Money **	10370/35105 = 29.5%	
*As at Feb. 1987 ** January 1987 *** January 1987		
Figures in millions of U.S. Dollars		
	MI (Converted to U.S. Dollars)	Broad Money (Converted to U.S. Dollars)
1977 (January)	7176	13,665
1987 (January)	9166	35,105
% Increase (decrease)	27.7%	156.8%
Corresponding % increase in the United States	116.5%	189.7%
(a) 1986 Imports as percentage of GNP 43.55%		
(b) 1977 - 1986 Imports as percentage of GNP 35.49%		
1986 /1977 - 1986 average) = (a)/(b) = 122.7%		
Source: IFS		

# 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	.7185-.7190	.7076-.7085	.6670-.6685	Remain long	Remain long
Belgian franc	37.77-37.80	37.64-37.73	37.44-37.55	Neutral	Remain long
Danish krone	6.8525-6.8575	6.8825-6.8945	6.9725-6.9975	Neutral	Remain short
Dutch guilder	2.0520-2.0530	2.0423-2.0438	2.0055-2.0100	Neutral	Remain long
Greek drachma	137.35-137.45	141.65-143.25	155.35-165.45	Neutral	Remain short
Hong Kong dollar	7.8075-7.8085	7.7995-7.8035	7.7675-7.7785	Sell 12 months at 7.65 to US \$ if available	
Italian lira	1317-1318	1318-1320	1320-1322	Neutral	Neutral
Kuwaiti dinar	.28220-.28230	.28130-.28190	.27790-.27970	Neutral	Remain short
Malaysian ringgit	2.5195-2.5205	2.5025-2.5050	2.5500-2.5570	Neutral	Neutral
New Zealand dollar	.5865-.5872	.5698-.5715	.5345-.5390	Remain long	Remain long
Norwegian krone	6.6750-6.6800	6.7940-6.8040	7.1100-7.1250	Neutral	Neutral
Saudi Arabian riyal	3.7500-3.7510	3.7450-3.7470	3.7400-3.7430	Remain short	Remain short
Singapore dollar	2.1165-2.1175	2.1055-2.1075	2.0765-2.0805	Neutral	Neutral
Spanish peseta	125.75-125.85	128.00-129.10	132.50-135.60	Neutral	Neutral
Swedish krona	6.3525-6.3575	6.3790-6.3840	6.4790-6.4895	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, May 26, 11:00 a.m.:

a) Short-term gold traders stopped out at 453, basis June, should buy them back immediately, as we think we bottomed out at 445.50.

b) Do not sell July silver on an 825 stop, close. Here, too, market has probably seen the lows and the sale on stop will be ineffective.

c) Buy back platinum (if stopped out on Friday) at market.

Stand by for further instructions after market closes. Place stops at the following levels: on gold, 450.50, basis August; on silver, 725.00, basis July; and on platinum, 563.00, basis July, all close only.

A repetition of this a.m.'s (11:00) flash update; followed by our stop recommendations:

1) Gold traders who were stopped out at 453.00, basis June, should buy back their position immediately.

2) Do not sell July silver at 825, stop close.

3) If stopped out of platinum at Friday's close, buy back at the market.

Place stops at the following levels:  
in gold, 450.50, basis August; in silver, 725.00, basis July; and in platinum 563.00, basis July, all close only.

**Flash update, Wednesday, May 27:** Sell June S&P at the market, placing stops at 292.50, good anytime.

A summary of yesterday's update: You are now again long gold, silver, and platinum with stops at 450.50, basis Aug., 725, basis July, and 563, basis July, respectively, all close only.

**Friday, May 29:** The market letter was mailed Tuesday, 27th May, 1987. A review of the week's activities: We are once again long gold, silver, and platinum. Our stops are 450.50, basis August, 725.00, basis July, and 563.00, basis July, respectively, all close only. You are once again flat the S&P, having been stopped out yesterday at 292.50. Stay posted for reentry opportunity.

**Tuesday, June 2:** No new changes or recommendations.

**Friday, June 5:** There are no changes or new recommendations.

**Flash update, Tuesday, June 9, 2:05 p.m.:** Sell June S&P at market, risking 298.00, good anytime. This will replace the regular update if there are no changes or new recommendations.

**Friday, June 12:** No changes or new recommendations. One note: You were stopped out of the S&P after selling it on the flash update on Tuesday.

**Tuesday, June 16:** No changes or new recommendations.

**Friday, June 19:** No changes or new recommendations.

**Tuesday, June 22:** No changes or new recommendations.

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