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The trade gap: turning the corner or rounding the bend?

The persistent US trade deficit continues to be the focus of attention. Many analysts attributed much of the increase in the trade deficit, from just over \$25 billion in 1980 to more than \$124 billion in 1985, to the dramatic rise in the foreign exchange value of the US dollar from mid-1980 to early 1985. With the substantive depreciation of the dollar since February 1985, most of these same analysts expected that, allowing for the usual lags associated with the so-called J-curve effect, the trade balance would improve in 1986. The deficit, however, did not decline. In fact, the 1986 trade gap ballooned to a record of just over \$144 billion. If this weren't enough, we have witnessed more of the same in the first five months of 1987. For example, the deficit in the first five months of 1987 exceeds (by 5%) that for the same period in 1986; it is less (by 4%) than the last five months of 1986; and if annualized, the 1987 deficit would exceed the record set for the year 1986.

Although the unrelenting trade gap has confounded those who hold the consensus view, it has not surprised us. For more than a year, we have repeatedly presented a variety of analyses that have shown why the J-curve crowd was engaging in wishful thinking, rather than analysis. Since it has been some time since we have written about the trade deficit and since those who hold the consensus view have become more adamant about the "fact" that we have "turned the corner" on the trade deficit, we believe it prudent to review the situation from yet another perspective.

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Changes in the foreign exchange value of the dollar will have an effect on US exports and imports only if the changes in the value of the dollar are passed through to the prices of goods. To put it in other words, for a change in the value of the dollar to cause a change in US imports and exports, the relative prices of imports and exports must change as a consequence of changes in the foreign exchange value of the dollar. For example, imports into the US will slow because of a dollar depreciation only if import prices rise relative to the

prices of domestically produced goods.

Chart 1 shows the exchange rate movements and associated changes in the relative price of US non-petroleum imports to US-produced goods. In the first period, the dollar depreciated by 11.5%, and there was a significant pass through to the prices of goods, with the prices of imports relative to domestically-produced goods rising by 9%. In consequence, prices alone acted to squeeze down the trade deficit. This relative price measure fell by more than 29% as the dollar appreciated by 46.3% from mid-1980 to early 1985. In this period, there was considerable pass through, and prices alone acted to increase the trade deficit. The dramatic turnaround in the dollar's movement, from February of 1985 through the second quarter of 1986, was not accompanied by a rise in the relative price of imports. In fact, the relative price of imports declined by 0.8%, even though the dollar depreciated by 25.6%. Hence, prices alone caused the deficit to deteriorate during this period. In the last period for which we have data (through the first quarter of 1987), the dollar declined (by 10.7%), and we have finally registered a small (1.2%) increase in the relative price of imports. In consequence, prices alone caused the deficit to shrink slightly.

Even though the foreign exchange value of the dollar has depreciated substantially against industrial country currencies, this decline has only recently started to be passed through to the relative price of imports. Moreover, the pass through and the increase in the relative price of imports have not been too significant. No wonder we haven't turned the corner on the trade deficit. All other things constant, we should not expect a turning of the corner (a significant reduction in the trade deficit) until there is a significant pass through and

Important Notice

We will not publish an issue in August (yes, even we take holidays). Instead, your subscription will be extended by one month. Meanwhile, you can still keep in touch with our Hotline.

a significant rise in the relative price of imports. Until then, we can anticipate that, at best, relative changes in the price of imports will cause nothing more than a slow rounding of the bend on the trade deficit.

* * * * *

A slow rounding of the bend will probably occur, even if the effective dollar exchange rate remains at current levels, because some of the dollar's past depreciation will eventually be passed through to higher import prices. However, even under these conditions, we do not anticipate a significant rise in the relative price of imports because domestic prices will be increasing at the same time.

This type of slow adjustment will not satisfy the markets. Market participants will grow increasingly weary of rounding the bend, and the dollar will once again come under attack. As the dollar depreciates there will be, unlike the period since February 1985, a significant pass through and an increase in the relative price of imports. The pass through will result from the fact that many exporters to the US have already had their profit margins on exports to the US cut to the bone. In consequence, to maintain their existing thin margins, many exporters will be forced to pass further appreciations in their domestic currencies through to US import prices. This will cause the relative price of imports to rise. Hence, it will accelerate the trade deficit adjustment as US consumers switch from foreign to domestically-produced goods.

As the dollar comes under attack, the Federal Reserve will be forced to engage in a defense to slow the dollar's fall. In consequence, there will be upward pressure on interest rates. Higher rates will slow the demand for goods by the US, and this will reduce the demand for imports. Hence, the dollar defense will also assist in the trade adjustment process.

* * * * *

Before closing our discussion of the trade deficit, it is important to mention that the US trade and current account figures, which are notorious for their inaccuracy, will proba-

bly be recorded on a different basis in the coming months. The first adjustment concerns the balance of trade. Specifically, the Canadians claim, and the US Department of Commerce has informally agreed, that US exports to Canada are being undercounted by \$10-\$12 billion annually. If the Department of Commerce fully adjusts for this, it would reduce monthly trade deficits by as much as \$1 billion. The second adjustment concerns the current account balance. Specifically, many governmental analysts claim that the Department of Commerce has been undercounting US exports of services. Although the claims about the magnitude of this undercounting vary, the Department of Commerce might consider increasing US exports of services by as much as \$1 billion per month. This adjustment would reduce the current account deficit by a like amount.

These adjustments, when and if they occur, will act to reduce, on a permanent basis, the balance on the trade and current accounts.

— By Steve H. Hanke

Chart 1
Percentage Change in Exchange Rates and Relative Prices

Time Period	Effective Dollar* Exchange Rate	Ratio of US Import Prices to US GNP Deflator
I/1977 - II/1980	- 11.5%	+ 9.0%
II/1980 - I/1985	+ 46.3%	- 29.4%
I/1985 - II/1986	- 25.6%	- 0.8%
II/1986 - I/1987	- 10.7%	+ 1.2%

*Effective exchange rate changes are an indicator of the extent to which the external value of a country's currency has moved relative to other currencies. Effective exchange rate changes are computed as an index, combining the exchange rates between the currency in question and 17 other major currencies with weights derived from the International Monetary Fund's "Multilateral Exchange Rate Model." Each weight represents the model's estimate of the effect on the trade balance of the country in question of a change of one percent in the domestic currency price of one of the other currencies. The weights, therefore, take account of the size of trade flows as well as of the relevant price elasticities and the feedback effects of exchange rate changes on domestic costs and prices. The measure is expressed as an index based on average exchange rates during 1980.

Implications of the Trade Gap

Interest Rate Futures

Having retraced almost 50% of the severe bear move initiated in March of this year, long bonds lost upside momentum, traded sideways to lower for two weeks, breaking their short-term uptrend from the May lows, and finally plunged to below 90. The gentle upward course of the US dollar in recent weeks, the relatively sharp correction of the CRB index, and the slight improvement in the outlook for the US budget deficit were not able to sustain this market.

This renewed decline in the face of apparently positive background news (not even collapsing crude oil prices last

week could offer solace) is the best technical proof that the path of least resistance for interest rates is northbound. Clearly the culprit seems to be inflationary expectations.

Market-sensitive data confirm the view that inflationary expectations have changed dramatically for the worse. Chart 2 depicts the ratio of US government long-term bond yields to the three-month T-bill rate, a proxy for the entire yield curve at one particular point in time: January and July of every year. Preliminary figures for this month indicate that the yield curve is at the *steepest point since the early '70s*, a period that preceded the most virulent inflation in US history

in over one century.

Skeptics may argue that the actual slope of the yield curve was steeper in the mid-'50s, late '50s, and early '60s (as can be seen in Chart 2). True, the actual slope of the yield curve does not forecast the impending absolute level of inflation. Instead, it forecasts the coming change in the *rate of change of inflation*. Thus the sharp upward-sloping yield curve of the '50s and early '60s signalled a dramatic change ahead in the rate of inflation (from 1% or less to more than 3% per annum, or roughly 300%!). The same can be said about the early '70s: Inflation moved from 3%-4% per annum to 10%-12% over the subsequent three years. Again, the steep yield curve experienced in 1976-77 signalled renewed acceleration of inflation that came to a head in the 1980-82 period.

The extraordinary steepening of the yield curve in recent months superimposed on an actual rate of inflation of 5%-6% per annum makes us believe that 1987-89 will see serious reacceleration of inflation, *easily leading to double-digit numbers*.

Inflationary expectations have leading and causal characteristics. On the one hand, as we have seen, they tend to lead actual inflation, perhaps because market participants understand rather well the process that leads to higher rates of inflation. On the other hand, these very same inflationary expectations begin to operate in commodity markets via the inventory effects we have been describing in the past number

of issues, thus causing inflation numbers to ratchet higher.

What is rather clear from the historical record, however, is that inflationary expectations, once set in motion, do not reverse unless the monetary authorities apply the brakes to the continuing money and credit expansion. The reversal in inflationary expectations — leading to a future deceleration in inflation — can be picked up by observing the yield curve: It narrows and finally goes negative.

It is also interesting to note that while inflationary expectations were relatively dormant during the past number of years, long-term interest rate volatility continued to increase vis à vis short-term rates (see Chart 3), an indication that market *uncertainty* regarding long-term interest rates (and *consequently inflation*) remained *high and rising*. In short, the market did not *really* believe the Feds were seriously committed to zero or even low inflation. This phenomenon could also have been observed by the persistence of apparently high real rates of interest — high for those who believed inflation would stay at 1%-3% per annum but reasonable (or even too low) for those who, correctly, distrusted the authorities.

STRATEGY: *We are short September '87 T-bond at just over 92, in keeping with the suggestion of selling when the short-term uptrend from the May lows was penetrated. Place initial stops at 94.00, good anytime.*

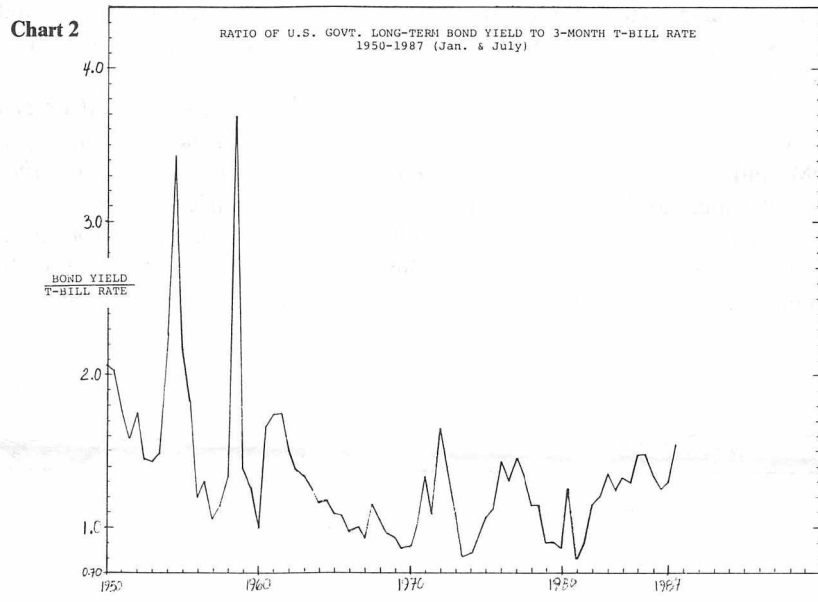


Chart 3 — Relative Interest-Rate Volatility

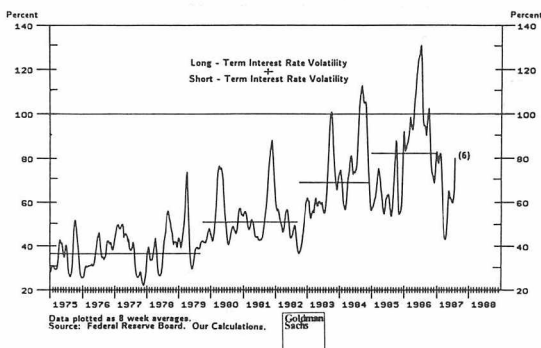
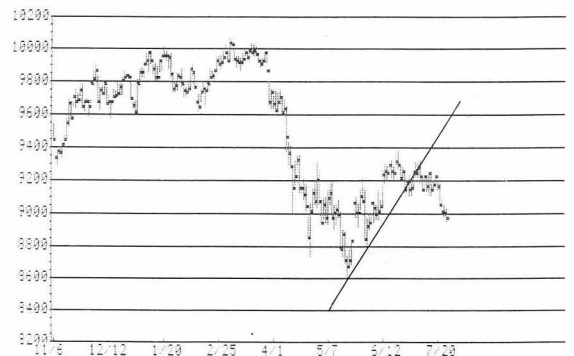


Chart 4 — CBT U.S. T-BONDS SEP 87



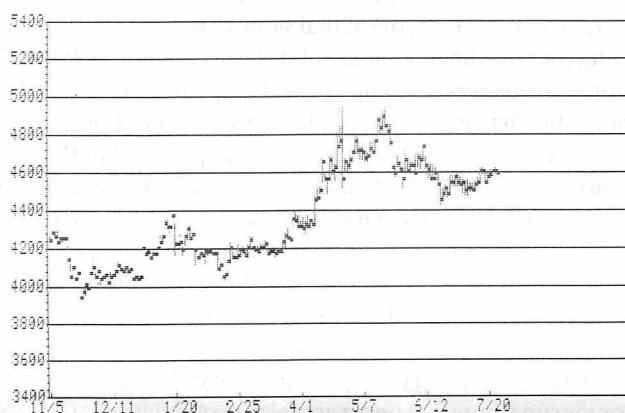
Gold

Gold is a certain beneficiary of accelerating inflationary pressures. Technically, the market is completing another high level consolidation, having successfully tested the \$440/oz. area of the previous recovery high. Gold is likely to gain upside momentum from this point: A test of the \$520/oz. level is in the cards.

STRATEGY: Remain firmly long. In the coming scenario, gold is certain to better its all-time high of \$825/oz. by a wide margin.

Short-term traders were advised to re-enter the long side of the market (over the Hotline) when August '87 closes above 450. It did. Place stops at 455 basis December '87, close only.

Chart 5 — COMEX GOLD OCT 87



Silver & platinum

The two minor precious metals seem set to move back on the bull track. The correction wreaked havoc with the weak longs: Silver's open interest collapsed to 81,000 contracts from almost 130,000 contracts at the end of April, while platinum shed more than 6,500 contracts (30% of the total outstanding at April 24).

Increased delivery at the Tokyo Commodity Exchange for Industry (TOCOM) and recovery in demand for jewelry have prompted a dramatic increase in Japanese imports of platinum. June imports reached 5.22 tonnes, up from 3.03 tonnes a year earlier, while cumulative January to June imports stand at 21.5 tonnes versus 14.99 a year earlier.

As pointed out in previous issues of *FC&CC*, platinum's fundamentals seem much stronger than silver's, as the demand for platinum is strongly underpinned by a well-orchestrated marketing campaign to retail small wafers and bars.

STRATEGY: Silver remains a volatile trading vehicle (not likely in the long run to gain on platinum and/or gold) with some upside bias. at this time.

Platinum, on the other hand, enjoys constructive fundamentals and should be added to serious portfolios.

Stops, in both cases, should be placed below recent reaction lows, good anytime.

Chart 6 — COMEX SILVER SEP 87

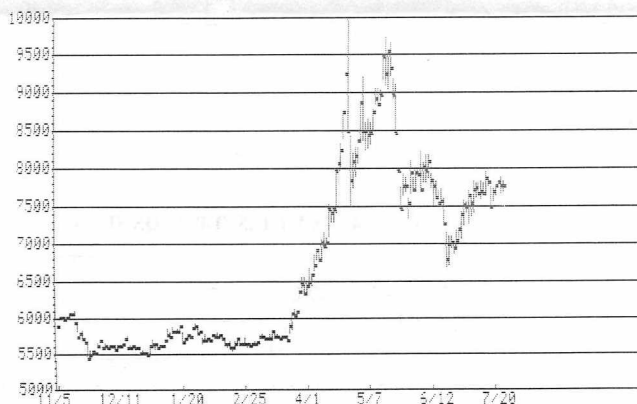
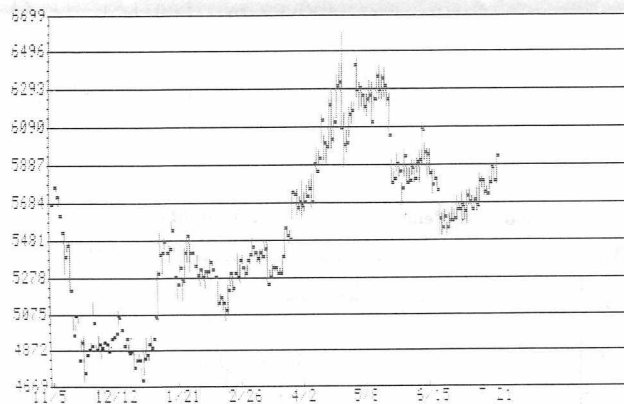


Chart 7 — NYME PLATINUM OCT 87



Copper

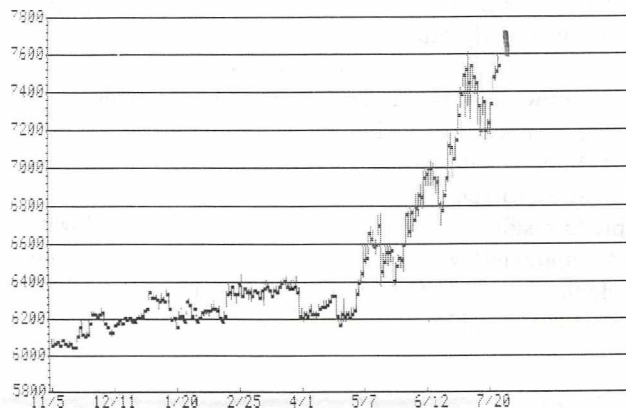
The steep 400 points-plus reaction on copper prices was caused and accompanied by the heavy liquidation of a speculative position, rumored to exceed 6,000 contracts.

Testimony to the market's extremely tight supply condition, nearby July widened its premium over September '87 to nearly 300 points from 100 points at July 9 (the day of the temporary top). At the same time, more than 2,000 July contracts remain open, an unusually large position days prior to contract expiration.

LME and COMEX warehouse stocks continue to decline, giving understocked merchants urgency to their quest for achieving proper inventory levels.

STRATEGY: Remain long; raise stops to 7150, basis September '87, good anytime.

Chart 8 — COMEX COPPER SEP 87



CRB Index

Led by the dramatic weakness in the grain sector (deflated by the coming of rain), the CRB index retreated just under 7% from its early May recovery high. The correction amounted to no more than 50% of the previous upmove. Excellent support, thus, should be found in the 216 to 220 area, basis spot.

Breadth continues to display remarkable strength (see Chart 10) and points to sharply higher prices.

STRATEGY: Remain long; note change in CRB components has lessened significantly the impact of gains, while, by implication, it has raised the influence of the bullish metals, meats, and cotton sectors.

Chart 10

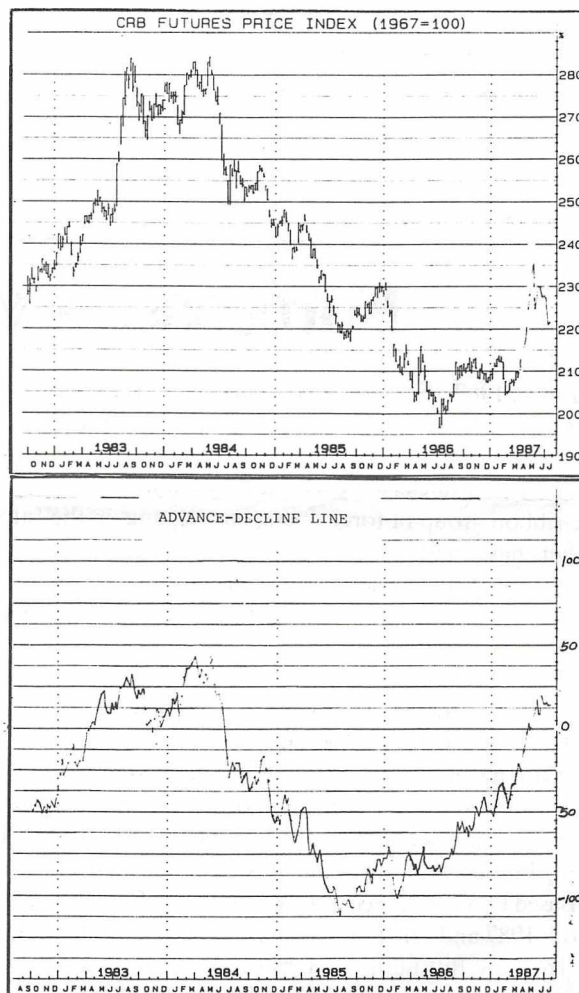
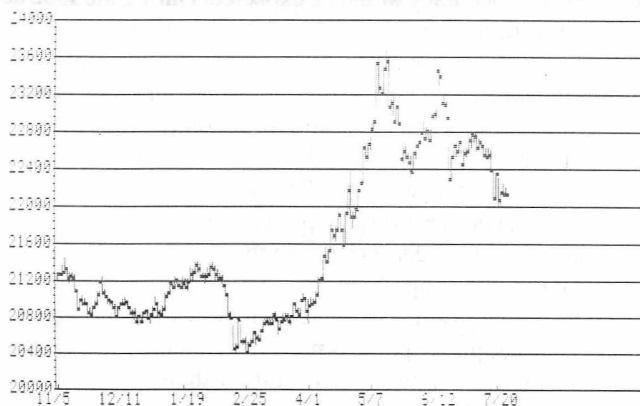


Chart 9 — NYFE CRB PR. IND CASH



US Dollar

Stalling, and turning rather quiet at just under DM 1.8750, the US dollar is giving every indication that the brief respite enjoyed since early May 15 is coming to an end. The trade balance is not improving rapidly enough for the reasons we outlined above and the market is likely to lose patience.

The US needs external financing for its current account deficit. Interest rate differentials between Eurodollars and Euro-DM/Euro yen deposit rates, however, have narrowed sharply (a result of the dramatic rise of the latter), slowing private capital inflows to a trickle. If private capital does not provide the oxygen, official intervention will: From end December 1986 to end May 1987, international reserves of West Germany, Japan, Great Britain, and Switzerland rose by a

staggering \$47 billion, just a bit under the probable \$62 billion US current account deficit. A test of the lower portion of the apparent forex band (DM 1.75, yen 137) will bring forth required financing.

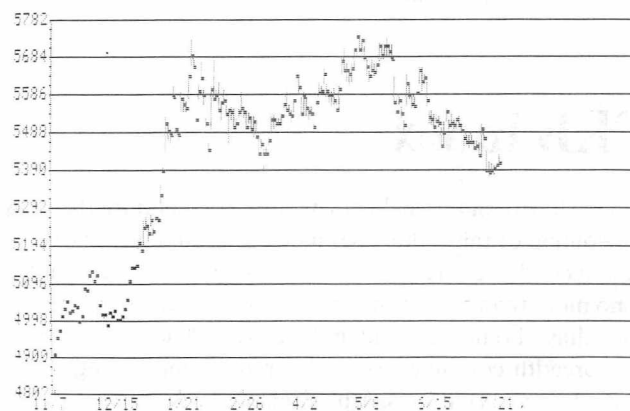
Expect a new attack on the dollar as soon as the DM/\$ breaks below 1.83 and the yen below 148. These levels translate roughly into 54.65, basis September '87 DM, and 67.30, basis September '87 yen.

STRATEGY: We stopped out long DM and yen positions as per our May 24 comments at 56.00 and 71.30 respectively. We now advise buying September '87 DM and September '87 yen on closes above 54.65 and 67.30, respectively.

Chart 11 — CME JAPANESE YEN SEP 87



Chart 12 — CME DEUTSCHE MARK SEP 87



Forecasters versus the markets

On July 6, 1987, the *Wall Street Journal* published the results of its semi-annual survey of professional economic forecasters. Among other things, the 35 participants made forecasts about interest rates (see Chart 15). In addition to the *WSJ's* blue-ribbon group of forecasters, participants in the futures markets have made forecasts about interest rates. For example, on July 2, 1987, the futures market forecast for interest rates on three-month Treasury bills for the end of December 1987 was 6.12% (100-93.88) and for the end of June 1988 was 6.55% (100-93.45). These market forecasts compare with the consensus (average) for *WSJ's* forecasters of 5.91% for December 1987 and 6.19% for June 1988.

With two methods of forecasting interest rates, the obvious question is: How do the methods compare? The answer to this question is contained in two recent articles: (1) "Predicting Interest Rates: A Comparison of Professional and Market Based Forecasts," *Federal Reserve Bank of St. Louis Review*, March 1987 and (2) "Forecasting Changes in Inflation Using the Treasury Bill Futures Market," *New England Economic Review*, March/April 1987. First, let's look at how the profes-

sional forecasters and the markets predicted the direction of change in interest rates. In the 1982-86 period, individual forecasters correctly anticipated the direction of change only 42% of the time. If interest rate movements are random, a 50% record of accuracy would be expected. During the 1982-86 period, the futures market, in fact, anticipated 50% of the directional changes that actually occurred in interest rates. Over a longer period (1977-86), the futures market's performance was a bit better, with the directional change anticipated almost 55% of the time. We can conclude that, when forecasting the changes in the direction of interest rates, the futures market outperforms the professional forecasters. However, the superior forecasts made in the futures markets leave plenty of room for improvement.

The second comparison between the forecasters and the futures market participants is more severe and concerns the actual estimates of interest rates, rather than their direction of change. Based on this test, forecasters don't do very well. For example, predictions of the three-month Treasury bill rate six months into the future by the professionals are within

two percentage points of the actual rate only about 67% of the time. Hence, if the T-bill rate was forecast to be 6%, there would be a 67% chance that the actual rate would fall between 4% and 8%. If we look at the forecasters' performance over time, it shows that from 1977 to 1981, when interest rates were rising, the forecasters were systematically underestimating interest rates. During this period, the futures markets significantly outperformed the professionals. From 1982 to 1986, when interest rates were falling, both the forecasters and the futures markets systematically overestimated interest rates. Based on the criterion of accuracy in predicting specific interest rates, the futures markets perform better than the professional forecasters. However, the performance of the futures markets leaves plenty of room for improvement.

* * * * *

Is there a theory to explain the superior performance of futures markets? The answer is yes. Participants in the futures markets have an incentive to use all available information to accurately predict interest rates because, once they enter the market, their own wealth is at risk. Hence, market participants are rewarded for good forecasts and penalized for poor ones.

Professional forecasters don't face the same incentives as market participants. The professionals' wealth is not as tightly linked to the accuracy of their forecasts as is that of the market participants. Also, just suppose that an individual could systematically anticipate interest rates better than the market does. In this case, the individual would probably not become a professional forecaster and publish a forecast. After all, he could directly use his valuable insights to increase

his wealth. The only limit on this would be his ability to take a position in the markets.

Implications: Comparisons of the track records of professional forecasters and the futures markets show that the futures markets have been closer to the target than professional forecasters. Hence, interest rate data from the futures markets provide more reliable interest rate forecasts than data provided by professional forecasters. What is intriguing is the fact that while futures markets are superior portenders of the future than professional forecasters, the futures markets have also been significantly wide of the target. This implies that there are plenty of opportunities to "beat the market."

Good luck!

— By Steve H. Hanke

Chart 15

	December Survey		July Survey			
	3-MO Bills (6/87)	30-YR Bonds (6/87)	3-MO Bills (12/87)	30-YR Bonds (6/88)	3-MO Bills (12/87)	30-YR Bonds (6/88)
High 20%	5.62%	7.79%	6.51%	7.14%	9.07%	9.47%
Low 20%	4.39	6.35	5.26	5.25	7.49	7.13
Average	4.98	7.05	5.91	6.19	8.45	8.57
Futures	5.22		6.12	6.55		
Actual	5.73	8.50				

Sugar: Not quite so sweet

Recently, we presented sugar production, consumption, and inventory data. These supported a rather bullish outlook for the world sugar market (see: *FC&CC*, May 24, 1987). Since then, F. O. Licht, the respected West German sugar statistics consultancy, has issued a revised estimate for production in the 1986-87 market year. Their new estimate is 103,890 thousand tons. This revision exceeds their preceding estimate of 101,845 thousand tons by 2%, and is, in large part, the result of increased estimates for production in sugar-importing countries.

Using the new 1986-87 production estimate (103,890 thousand tons) as a base, we have revised our production, consumption, inventory, and price projections (average March futures closing prices for the October through December period). Chart 16 contains the new projections: As indicated, production is higher; consumption (disappearance) is slightly higher (smaller price increases allow for somewhat higher consumption levels); stocks decline less rapidly; and prices increase less rapidly.

As a consequence of these new fundamentals, we have pushed the arrival date for the start of a sustained bull market back from late in the calendar year 1988 to late 1989. Moreover, we have reduced the length of time that a bull market can be sustained, and hence the maximum price that will be reached during such a market. The reason for our reduced expectations about the duration and amplitude of a bull market requires further comment.

When actual sugar stocks fall to about 25% of consumption or less, desired stocks will exceed the actuals and prices will be bid up in a sustained manner. Higher prices will act to reduce consumption and increase production, so that actual stocks can be built up to desired levels. Now, the longer it takes for these price signals to do their job, the longer will be the bull market and the higher will be the peak prices.

Since the last bull market in sugar (1981), the structure of the world sugar market has changed somewhat. On the demand side, the developing countries' share of world market demand has increased from about 35% in the mid-1970s

to about 60%. The developing countries' demand for sugar is much more responsive to price changes than the developed countries' because the developing countries are much less able to bear the burden of price increases than the developed countries. In consequence, the world demand for sugar has become more responsive to price changes. On the supply side, beet sugar has increased its share of the world market, primarily because of the European Community's increasing role in world sugar trade (the EC is a beet producing region). Since beet sugar's supply response to increasing prices is more rapid than cane sugar's, it takes less time for world supply to react

to price signals than it once did.

As a consequence of more rapid demand and supply responses to increased sugar prices, inventory adjustments can occur over a shorter time span. Hence, bull markets will be shorter in duration and price increases less dramatic.

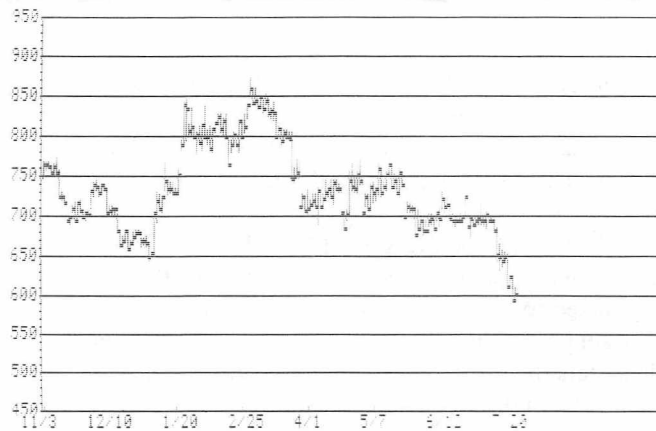
STRATEGY: On July 21, 1987, March 1988 sugar closed at 6.74 cents per pound. This was below our recommended initial stop of 6.85 cents per pound (see: FC&CC, May 24, 1987). In consequence, we are on the sidelines, and for the time being, intend to stay put.

Chart 16
WORLD SUGAR: PRODUCTION, DISAPPEARANCE, STOCKS,
MCH FUTURES CLOSES

	Production		Disappearance		Ending Stocks		Mch Future Ave of closes Oct 1-Dec 31
	000 MT	% of 3-yr-ave	000 MT	% of 3-yr-ave	000 MT	% of disapp	
61/62	52351	100.2	55968	112.3	13463	24.05	2.57
62/63	51172	97.2	54342	103.0	10293	18.94	3.87
63/64	54745	102.9	53909	98.6	11129	20.64	10.11
64/65	66831	126.7	59191	108.1	18769	31.71	3.17
65/66	62328	108.2	62105	111.3	18992	30.58	2.29
66/67	64765	105.7	64850	111.0	18907	29.15	1.57
67/68	65626	101.5	64897	104.6	19636	30.26	2.54
68/69	66828	104.0	67307	105.2	19157	28.46	2.72
69/70	72981	111.0	71014	108.1	21124	29.75	3.22
70/71	71030	103.7	73403	108.4	18751	25.55	4.10
71/72	72309	102.9	73206	103.7	17854	24.39	5.33
72/73	75550	104.8	77005	106.2	16399	21.30	8.15
73/74	78932	108.2	79209	106.3	16122	20.35	10.24
74/75	78263	103.5	76915	100.6	17470	22.71	46.49
75/76	81581	105.2	78573	101.1	20478	26.06	13.72
76/77	86950	109.2	82222	105.1	25206	30.66	8.46
77/78	91033	110.7	85747	108.2	30492	35.56	8.89
78/79	90965	105.1	90250	109.8	31207	34.58	8.92
79/80	84857	94.7	90271	104.9	25793	28.57	14.89
80/81	88213	99.2	89091	100.4	24915	27.97	38.05
81/82	100732	114.5	92264	102.7	33383	36.18	12.68
82/83	100641	110.3	94960	104.9	39064	41.14	7.33
83/84	98022	101.5	97181	105.5	39905	41.06	9.69
84/85	100440	100.6	100270	105.8	40075	39.97	5.38
85/86	98727	99.0	101046	103.7	37756	37.37	5.90
86/87	103890	104.9	103546	104.1	38100	36.80	6.64
87/88	103000	102.0	105400	103.7	35700	33.87	7.50 pj
88/89	104000	102.1	107300	103.8	32400	30.20	10.00 pj
89/90	105000	101.3	109400	103.8	28000	25.59	15.00 pj

Source: Commodity Associates

Chart 17 — N.Y. #11 SUGAR OCT 87



Crude Oil

In a final paroxysm of buying, the oil market "blew off" at \$22.75/barrel in the belief that a Gulf war would completely cut off supplies for the indefinite future.

This climatic top went a great deal further than we had anticipated, buoyed by political/military events. With prudence being the better part of valor we beat a strategic retreat last May (admittedly a smidgen (!) late), advising covering all short positions at the then 18.80 level, basis September '87.

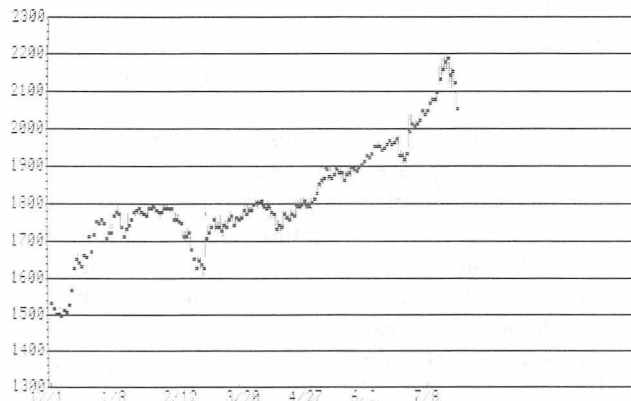
As it turns out, the fundamentals remain as bearish as ever. Consumption stagnates, Opec members cheat (Iraq among others in great style), refining margins collapse. And now, there is even a possibility that Iran may accept a negotiated settlement with Iraq that will not contain the two unacceptable conditions: Saddam Hussein's resignation and a yet undetermined reparation payment (a few years ago it was running at \$50 billion).

While skirmishes and terrorist attacks will most probably occur from time to time, a full-blown Iran-US war is unthinkable, as US firepower is overwhelming.

The crude oil market has finally turned down; we are jumping back on the bandwagon.

STRATEGY: Sell January '88 at market, place stops at 21.50, good any time.

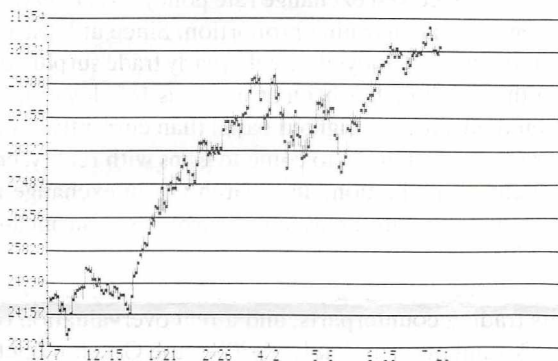
Chart 18 — NYME CRUDE LIGHT SEP 87



Stock Indexes

STRATEGY: Stopped out of short positions at 313.60. Remain sidelined.

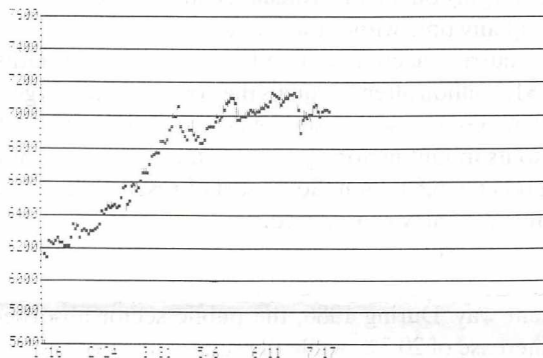
Chart 19 - CME S&P 500 INDEX NOV 87



Australian dollar

STRATEGY: Remain long; leave stops at 68.95, basis September '87.

Chart 20 - CME AUSTRALIAN DLR SEP 87



Friedberg Capital Markets

Chart 22 - Foreign Currency Bonds

DATE: July 23, 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
NEW ZEALAND DOLLAR DENOMINATED BONDS					
COCA COLA 16/6/89 18%	192 1/8	- 102 7/8	16.02	16/6/87	-16/6/88
HONDA INT'L 20/9/89 3/8%	98 3/4	- 99 1/2	16.38	20/6/86	-20/9/87
HONDA INT'L 28/5/90 16%	99 1/2	- 100 1/4	15.44	28/11/86	-28/5/88
TOURIST HOTEL CORP. (N.Z.) 4/6/93 zero coupon	43 1/2	- 44 1/2	14.86	matures 4/6/93	
BANK OF NOVA SCOTIA 15/9/89 18% RRSP eligible	103 3/8	- 104 1/9	15.77	15/5/86	-15/9/87
WELLS FARGO (semi-ann.) 12/5/89 16 1/8%	98 1/2	- 99 1/4	17.26	12/5/87	-12/11/87
KODAK (semi-ann.) 15/2/89 17%	101 1/2	- 102 1/4	15.87	12/2/87	-15/8/87
TORONTO DOMINION 2/4/90 18% RRSP eligible	103 3/4	- 104 1/2	15.67	2/4/87	- 2/4/88
AUSTRALIAN DOLLAR DENOMINATED BONDS					
CAN. IMP. BANK OF COMMERCE 13/3/91 13% RRSP eligible	99 1/4	- 100	12.93	13/3/87	-13/3/88

ISSUER MTY. DATE/COUPON	BID	OFFER	CURRENT ANNUAL YIELD TO MTY.	LAST PAY DATE	NEXT PAY DATE	
DEUTSCHE MARK DENOMINATED BONDS						
REPUBLIC OF PORTUGAL 19/6/94 6 5/8%	100 3/8	- 101 1/8	6.41	19/6/87	- 19/6/88	
GOVT. OF BELGIUM 29/4/96 5%	91 7/8	- 92 5/3	6.63	29/4/87	- 29/4/88	
QUEBEC HYDRO 1/5/96 5% RRSP eligible	93.55	- 94.30	6.36	1/5/87	- 1/5/88	
SWISS FRANC DENOMINATED BONDS						
GOVT. OF AUSTRALIA 30/10/98 5%	102 1/4	- 103	4.65	30/10/86	-30/10/87	
JAPANESE YEN DENOMINATED BONDS						
GOVT. OF CANADA 23/7/93 5 5/8% RRSP eligible	101 3/4	- 102 1/4	5.18	23/7/87	-23/7/88	
U.S. DOLLAR DENOMINATED FLOATING RATE NOTES						
ISSUER	MAT. DATE	COUPON	BID	OFFER	CURRENT COUPON	NEXT COUPON DATE:
UNITED KINGDOM	7/10/92	3 month LIBID (quarterly)	99.87	-100.12	6 7/8%	7/10/87
SANTA BARBARA SAVINGS & LOAN	18/12/95	pays 1/8% over 3 month LIBOR (quarterly) (fully collateralized)	99.87	-100.17	7 5/16%	18/9/87

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

Chart 21
Breakeven exchange rates for US\$ - based investor

This analysis shows a "snapshot" of the relationship between interest rate differentials and rates of exchange. The breakeven rate measures how far the foreign currency has to devalue (for NZ\$, A\$) or revalue (for DM, SF, JY), before the interest rate advantage/disadvantage is overcome by currency depreciation/appreciation. Bond yields and rates of exchange as of July 23, 1987.

	U.S. \$	NEW ZEALAND \$	AUSTRALIAN \$	DEUTSCHEMARK	SWISS FRANC	JAPANESE YEN
2 year	7.41%	Wells Fargo 16% '89 yield 17.26% (.51 NZ/US)**				
3 year	7.73%	Toronto Dominion 18% 2/4/90 yields 15.67% (.491 NZ/US)				
4 year	7.94%		C.I.B.C. 13% 13/3/91 yields 12.93% (.59 A/US)			
6 year	8.17%	Tourist Hotel 0% 4/6/93 yields 14.86% 1.424 NZ/US)				Canada 5% 23/7/93 yields 5.18% (127.8 US/JY)
7 year	8.34%			Portugal 6% 10/6/94 yields 6.41% (1.636 US/DM)		
9 year	8.41%			Belgium 5% 29/4/96 yields 6.63% (1.599 US/DM)		
11 year	8.57%				Australian 5% 30/10/98 yields 4.65% (1.027 US/SF)	
Spot Exchange Rate	N/A	0.608	.709	1.856	1.539	151.2

**For example, in parentheses, since a US\$ based investor would receive 985 basis points (17.26% minus 7.41%) by holding the Wells Fargo bond, the NZ\$ can depreciate to .51 NZ/US from the spot exchange rate of .608 NZ/US over the next two years for the NZ\$ investment to break even with current US rates of interest. Assumes that bonds are held to maturity, and all coupons are reinvested at the original yield.

The Exotics

Greek drachma

Greece is sitting on top of a volcano, and the volcano is likely to erupt at any time without warning.

The current account deficit for the first four months of 1987 at \$1.2 billion already equals the government's target for all of 1987. Greece will easily be adding during 1987 \$2-\$4 billion to its mounting foreign debt, which at the end of last year stood at \$16.8 billion. Some sort of rescheduling by the end of this year may be required.

At the heart of Greece's problem lies a grotesque public sector that consumes the nation's real resources and in a most inefficient way. During 1986, the public sector absorbed a credit increase of 20.5%, while the suffocating private sector had to content itself with an increase of 11%, well below the "official" inflation rate of 17%. Price freezes and other subterfuges are giving the appearance of a relatively modest rate of inflation; the enormous increases in strikes and social unrest belies the statistics. Prime Minister Andreas Papandreu's Third World posturing does very little to attract and or retain foreign capital, making hash of government projections of \$1.15 billion in capital inflows.

Statist policies coupled with inflationary financing and a politically conceived exchange rate policy have overvalued the drachma in an alarming proportion. Since at least 1970, the country has not enjoyed a single yearly trade surplus, even though the drachma has been as much as 18% lower in real terms (and on a trade weighted basis) than currently. Sooner or later Greece will need to come to grips with reality, erase the present overvaluation, and search for an exchange rate level that will generate a reasonable surplus and the means to pay its bills.

With inflation running a solid 20 percentage points higher than its trading counterparts, and a real overvaluation of at least 18% (and most probably 25-30%), the Greek monetary authorities would be well advised (and of course inevitably they will be forced) to devalue substantially.

A rate of 200 drachmas to the US dollar seems a reasonable objective within 12 months and 275-300 a modestly reasonable objective inside of 24 months.

STRATEGY: Sell deferred drachma positions (preferably 12-24 months) short with gusto against both the US dollar and DM.

Chart 23

YEAR	GREEK DRACHMAS PER U.S. DOLLAR (PERIOD AVG.)		U.S. 1973-1.00		U.S. 1978-1.00	
	U.S. DOLLAR (PERIOD AVG.)	U.S. 1973-1.00	U.S. 1978-1.00	1973-1.00	1978-1.00	
1967	30.0000	0.9993	1.1284	0.8543	0.8385	
1968	30.0000	1.0370	1.1711	0.8408	0.8253	
1969	30.0000	1.0679	1.2060	0.8600	0.8441	
1970	30.0000	1.1002	1.2424	0.8949	0.8783	
1971	30.0000	1.1131	1.2570	0.9455	0.9280	
1972	30.0000	1.1028	1.2453	1.0061	0.9874	
1973	30.0000	1.0000	1.1293	1.0000	0.9815	
1974	30.0000	0.8853	0.9997	0.8888	0.8724	
1975	32.2870	0.9167	1.0352	0.9734	0.9554	
1976	36.5180	0.9695	1.0948	0.9972	0.9787	
1977	36.8380	0.9285	1.0485	0.9955	0.9771	
1978	36.7450	0.8855	1.0000	1.0189	1.0000	
1979	37.0400	0.8343	0.9421	1.0015	0.9829	
1980	42.6200	0.8728	0.9856	1.0602	1.0405	
1981	55.4100	1.0062	1.1363	1.0457	1.0263	
1982	66.8000	1.0637	1.2012	1.0183	0.9995	
1983	88.0600	1.2039	1.3595	1.0748	1.0549	
1984	112.7200	1.3570	1.5324	1.1036	1.0832	
1985	138.1200	1.4424	1.6289	1.1446	1.1234	
1986	139.9800	1.2120	1.3687	1.1237	1.1029	
1987 (1Q)	134.4500	1.0783	1.2176	1.0840	1.0640	

----- BASKET -----
 U.S. 8% Saudi Arabia 11%
 France 11% Netherlands 9%
 Germany 30% Japan 7%
 U.K. 8% Italy 16%

Above 1.00 = undervalued
 Below 1.00 = overvalued

Chart 24

Year	Foreign Assets (Min US\$)	CURRENT ACCOUNT As % of GNP	CUMULATIVE 12 QTR. Current Account (Min US\$)
1970	356	-4.15	-1048
1971	396	-3.05	-1127
1972	853	-3.09	-1166
1973	771	-7.08	-1933
1974	543	-5.89	-2732
1975	165	-4.06	-3209
1976	-418	-3.99	-2949
1977	-822	-3.98	-2881
1978	-1347	-2.93	-2959
1979	-1615	-4.74	-3916
1980	-1319	-5.32	-5000
1981	-1768	-6.32	-6000
1982	-2386	-4.80	-6509
1983	-2486	-5.32	-6178
1984	-2272	-6.31	-5902
1985	-2068	-9.88	-7286
1986	-2690	-4.46	-7162

Chart 26

Spot	1 Month	3 Month	6 Month	12 Month
139.75-	141.25-	144.05-	148.25-	157.75-
139.95	141.95	145.80	152.45	164.95

Chart 25

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

Reserves * + Previous 12-months current Account *** = 1478
 (Reserves + 12-months C/A) / ML ** = 1478/5656 = 26%
 (Reserves + 12-months C/A) / Broad Money ** = 14781 23566 = 6%

*As at May 1987 ** Nov. 1986 *** 1987 Estimate

Figures in millions of U.S. Dollars

	ML (Converted to U.S. Dollars)	Broad Money (Converted to U.S. Dollars)
1977	5256	15161
1986 (Nov.)	5656	23566

% Increase (decrease) 7.6% 55.4%

Corresponding % increase in the United States 108% 108

(a) 1985 Imports as percentage of GNP 28.1%
 (b) 1976 - 1985 Imports as percentage of GNP 21.1%
 1985 /1976 - 1985 average) = (a)/(b) = 133%

Source: IFS

Danish krone

Denmark has accomplished a remarkable turnaround in its fiscal accounts. From a deficit of DKr 54 billion in 1983 it has improved steadily to record a DKr 21 billion surplus in 1986, equal to 3.25% of GDP. For 1987, the surplus is expected to drop to DKr 10 billion. With the contraction of the public sector came a slowdown in the rate growth of GNP; it grew 4.25% by volume in 1985, 3.50% in 1986, and will probably have a negative of 0.25% in 1987 after a series of austerity measures imposed last autumn. Denmark's intractable current account deficit problem remains mostly unresolved. From a record DKr 34.5 billion shortfall in 1986, the deficit is expected to shrink to between DKr 17 and DKr 18 billion in 1987 — despite the fact that GNP is expected to contract as we stated and that unemployment will rise to close to 9% this year from 7.8% at the end of 1986.

Denmark is on the horns of a dilemma: On one hand it has made very substantial progress in government finances; on the other hand, the booming conditions of 1983 to mid 1986 seriously overvalued the Danish krone, validating a cost structure that is not compatible with equilibrium in external

accounts and moderate growth. The government has then two choices, one perhaps more unpalatable than the other. It could continue to "squeeze" the economy for another two or three years, risking a further and significant rise in the unemployment rate in the hope that its trading partners' costs catch up to its own, at which point the current account moves into surplus. This seems to be the valiant approach of the present government, only months away from the next general election. It runs the risk of wearing out the population before the process is completed. Or it could attempt to devalue à la Sweden in 1982, hoping that the relatively large slack in the economy does not allow a cost pass through and thus obtain a one-time competitive advantage without seriously risking a rise in unemployment. At this stage, a real devaluation of 10% is probably sufficient.

The latter course seems to be the more sensible one should unemployment rise much faster than projected. It is, however, unlikely that this will take place before the election, given the government's strong stand against devaluation.

STRATEGY: Remain short against the DM and neutral against the dollar.

Chart 27

YEAR	DANISH KRONER PER U.S. DOLLAR (PERIOD AVG.)	BASKET			
		U.S. 1972 -1.00	U.S. 1979 -1.00	U.S. 1972 -1.00	U.S. 1979 -1.00
1967	6.9871	1.0777	1.6566	1.0265	1.2578
1968	7.4845	1.1114	1.7084	0.9890	1.2118
1969	7.5192	1.1389	1.7507	1.0079	1.2350
1970	7.4995	1.1285	1.7347	1.0101	1.2378
1971	7.4057	1.0973	1.6868	1.0298	1.2618
1972	6.9493	1.0000	1.5371	1.0000	1.2254
1973	6.0495	0.8433	1.2963	0.8975	1.0998
1974	6.0949	0.8189	1.2587	0.8679	1.0635
1975	5.7462	0.7697	1.1831	0.8590	1.0526
1976	6.0450	0.7859	1.2080	0.8273	1.0137
1977	6.0032	0.7479	1.1496	0.8186	1.0030
1978	5.5146	0.6719	1.0328	0.7922	0.9707
1979	5.2610	0.6506	1.0000	0.8161	1.0000
1980	5.6359	0.7040	1.0822	0.9237	1.1344
1981	7.1234	0.8795	1.3519	1.0065	1.2333
1982	8.3324	0.9910	1.5232	1.0326	1.2653
1983	9.1450	1.0503	1.6145	1.0047	1.2311
1984	10.3570	1.1670	1.7939	1.0195	1.2492
1985	10.5960	1.1799	1.8137	1.0167	1.2459
1986	8.0910	0.8868	1.3631	0.8873	1.0872
1987 (1Q)	6.9500	0.7600	1.1682	0.8182	1.0026

Above 1.00 = undervalued
below 1.00 = overvalued

Chart 28

Year	Foreign Assets (MLN US\$)	CURRENT ACCOUNT As % of GNP	CUMULATIVE 12 QTR. Current Account (MLN US\$)
1970	446	-3.44	-1170
1971	618	-2.40	-1379
1972	1180	-0.03	-1032
1973	1229	-1.67	-964
1974	1258	-3.10	-1519
1975	994	-1.31	-1946
1976	1135	-4.64	-3384
1977	2274	-3.74	-4126
1978	3428	-2.70	-5138
1979	3631	-4.58	-6189
1980	3857	-3.81	-6933
1981	3159	-3.38	-7306
1982	2842	-4.21	-6600
1983	3578	-2.17	-5310
1984	3398	-3.15	-5072
1985	6687	-4.97	-5541
1986	5104	-7.68	-8686

Chart 30

Spot	1 Month	3 Month	6 Month	12 Month
7.0275-	7.0385-	7.0765-	7.1450-	7.2300-
7.0325	7.0505	7.0885	7.1600	7.2550

Chart 29

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

Reserves + Previous 12-months current Account *** = 6382
(Reserves + 12-months C/A) / ML ** = 6382/28158 = 22.6%
(Reserves + 12-months C/A) / Broad Money ** = 6382/53651 = 11.9%
*As at May 1987 ** January 1987 *** 1987 Estimate

Figures in millions of U.S. Dollars

	ML (Converted to U.S. Dollars)	Broad Money (Converted to U.S. Dollars)
1977	10186	22187
1987 (Jan)	28158	53651

% Increase 176.4% 141.4%
(decrease)

Corresponding % increase in the United States 99% 112%

(a) 1986 Imports as percentage of GNP 39.8
(b) 1977 - 1986 Imports as percentage of GNP 30.4%
1986 / 1977 - 1986 average = (a)/(b) = 130.9%

Source: IFS

Forex Rates & Update

Currency	Spot	3-Month	12-Month	Comments vis à vis US\$	Comments vis à vis DM (Spot DM: 1.8550)
*Belgian franc	38.38-38.43	38.31-38.41	38.13-38.43	Buy	Remain long
*Dutch guilder	2.0860-2.0870	2.0773-2.0788	2.0425-2.0450	Buy	Remain long
Hong Kong dollar	7.8075-7.8085	7.7945-7.7975	7.7675-7.7935	Sell 12 months at 7.65	to US if available
*Italian lira	1340-1342	1341-1343	1344-1347	Buy	Neutral
Kuwaiti dinar	.28380-.28410	.28280-.28347	.27890-.28050	Neutral	Remain short
Malaysian ringgit	2.5450-2.5460	2.5225-2.5255	2.4750-2.5160	Neutral	Neutral
New Zealand dollar	.5985-.5995	.5805-.5825	.5405-.5455	Remain long	Remain long
Norwegian krone	6.7675-6.7725	6.8820-6.8910	7.1875-7.2025	Neutral	Neutral
Portugese escudo	144.80-145.30	147.60-148.60	150.80-161.30	Remain long	Neutral
Saudi Arabian riyal	3.7500-3.7505	3.7475-3.7495	3.7410-3.7465	Remain short	Remain short
Singapore dollar	2.1130-2.1140	2.1020-2.1040	2.0705-2.0765	Neutral	Neutral
*Spanish peseta	126.95-127.05	129.95-130.65	135.95-137.05	Buy	Neutral
*Swedish krona	6.4500-6.4550	6.4835-6.4925	6.6115-6.6260	Buy	Neutral
Venezuelan bolivar	29.00-29.20	Not available	Not available	Commercial hedgers remain short	

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, Thursday, June 25, 2:00 p.m.:

Due to the Canadian mail strike, we are giving you a quick preview of some of the most immediate recommendations in the market letter.

1. Sell Sept. S&P at the market, risking 313.60, good anytime.
2. Buy Sept. Australian dollar at the market on the IMM.
3. Buy Sept. copper at the market, risking 66.00, close only.

Friday, June 26: The market letter was mailed today. Due to the Canadian mail strike, we will highlight the features.

1. Sell Sept. S&P at the market, risking 313.60, good anytime.
2. Buy Sept. Australian dollar contract, now trading on the IMM exchange.
3. Buy Sept. copper at the market, risking 66.00, close only.
4. Having broken the short-term uptrend begun in May, sell Sept. T-bonds at the market, risking 94.01 stop, good anytime.

Tuesday, June 20: Market letter was mailed last week. One note: Short-term traders, stopped out of their long gold positions, should reinstate their long positions, if either of the following two conditions are met.

1. The market opens higher tomorrow July 1, basis August, meaning that the high of the opening range is above today's close, OR
2. The market closes at or above 453.00, basis August.

Friday, July 3: A review of the week's activities, including a brief summary of the market letter, which may not have reached all of you, due to the Canadian postal strike.

1. Traders were advised Tuesday to reinstate their long gold positions on a higher opening OR a close above 453.00, basis August. Neither

condition was met. Please note that a close above 453.00, basis August, should remain the criteria for re-entry by traders of the gold market.

Now, highlights of the market letter.

1. Short Sept. S&P at the market, risking 313.60, good anytime.
2. Short Sept. T-bond with a stop at 94.01, good anytime.
3. Long Sept. Australian dollar on the IMM exchange.
4. Long Sept. copper, risking 66.00, close only.

Tuesday, July 7: One stop recommendation. Liquidate long Australian dollar position if the market opens lower tomorrow, July 8.

Friday, July 10: No changes or new recommendations. One note: On Tuesday we recommended liquidating long Australian dollar positions in the event of a lower Wednesday opening. This did not happen. Therefore we remain long. Place stops at 68.95, basis Sept., good anytime.

Tuesday, July 14: No new changes or recommendations.

Friday, July 17: Please be aware that short-term traders were stopped back into the long side of gold on Wednesday, July 15, on a close above 453.00, basis August, as per our recommendation of Friday, July 3. Place initial stops at 444.00, close only, or for those holding December positions, use a stop of 455.00, close only.

Tuesday, July 21: No changes or new recommendations.

Friday, July 24: No changes or new recommendations.

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