FRIEDBERG'S

COMMODITY & CURRENCY COMMENTS

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Near-boom conditions

While economic *growth* in the US is not accelerating in any meaningful way, the rising tide of activity is slowly bumping against capacity constraints. The most notable such measure is unemployment, which at 6% stands at the lowest level in seven and one half years (Chart 1). More on employment: help wanted ads have climbed to the highest level in this recovery, forecasting strong demand for labor; initial unemployment insurance claims recently have hovered around 300,000, the lowest since 1974.

Other measures such as vendor performance, operating rates, and industrial commodity prices also confirm the impression that the economy is entering a stressful phase.

What are the main characteristics of this phase? Strong inflationary pressures, no balance of trade adjustments (see next article), rising interest rates.

Boom conditions, before they get choked off by capacity constraints, eroding profit margins, and rising interest rates, can last up to 18 months (no precision is implied!). Soon thereafter, the economy plunges into a recession.

Stock markets can discount the coming recession well ahead of it, as in December 1972 (11 months) or slightly ahead of it, as in March 1969 (4 months).

Near-boom conditions means the party is *nearly* over.

Chart 1

Can the dollar do the job alone?

Politicians and investors have become increasingly mesmerized by the monthly US balance of trade figure. Foolish as it may seem, the monthly trade deficit appears to be the most important number by which the nation's economic performance is being judged. Since investors expect this dubious trade statistic to continue to dominate US economic policy, we offer some further reflections on the matter.

Since our last analysis of the trade deficit (see *FC&CC*, July 26, 1987), two monthly trade figures have been released. The deficit for June was $15.7 billion, up from $14 billion in May. The June statistic caught the market by surprise because virtually everyone (fortunately, not us) had talked them-

In this issue

Mesmerized by the US balance of trade figure? Well, snap out of it! Higher interest rates are on the way, so we're aggressively short T-bonds. The bull market in stocks is running out of steam (to say nothing of time and money), so we're shorting that too. Plus oil (and why we're, yes, short), currencies (exotic and mundane), and Friedberg Capital Markets. Contributions by Albert D. Friedberg, Steve H. Hanke, Daniel A. Gordon, and Michael D. Hart.

selves into believing that exchange rates alone could cause a massive trade adjustment, that the US had turned the corner on trade, and that the trade deficit had begun to shrink. Even though the deficit for July surged to a record of $16.5 billion, it was greeted with some relief by the markets, where rumors of a deficit as high as $20 billion had circulated. What a difference a month can make!

* * * * *

To understand why the US has a trade deficit, we must look in a surprising place: the relation between the nation's domestic savings and investment (or what is called net domestic financial savings). Allowing for statistical errors, total net domestic financial savings (or deficit) must equal our international current account surplus (or deficit), where the current account equals balances for merchandise trade, trade in services, and unilateral transfers (gifts). When, for example, net domestic financial savings are in deficit, the nation must have net imports of goods and services that are equal to the differences between domestic environment and savings.

Chart 2 shows that net domestic financial savings are divided into three components: net household savings (household savings minus residential investment), net business savings (business savings minus nonresidential investment), and government savings (federal, state, and local taxes minus government expenditures at all levels). It should be clear from these data that the nation is saving less than it is investing. In consequence, we must import foreign goods and services to make up the difference.

To put it another way, Americans are spending more than they are producing (and foreigners are spending less), and the gap between domestic spending and production is being filled by the importation of goods and services from abroad.

Now, in economics, large imbalances cannot be sustained forever. In the case of trade, Americans will not continue to spend more than they produce, while foreigners spend less. An adjustment in net domestic financial savings and, therefore, our trade balance must occur. The questions are: Through what channels, and when, will the adjustment take place?

As can be seen by a little reflection on the components of Chart 2, there are many ways that net domestic financial savings could be increased to close the trade gap, and each would have greatly different effects on the economy. For example, consider the government deficit. A reduction in this deficit could be obtained by cutting public spending and/or increasing taxes. As a result, our international current account deficit would be reduced by an equal amount. But, the means used to tighten fiscal policy would have dramatically different effects on the economy. If a reduction in government spending is the mechanism used to reduce the public deficit, the economy's long-term health would improve. Alternatively, if the government deficit is reduced by increasing taxes, the economy's long-term health would be damaged.

* * * * *

We now address our primary analytical concern: can the foreign exchange rate mechanism (the depreciation of the dollar), by itself, reduce domestic consumption (increase net domestic financial savings) and free up domestic productive capacity, so that it can be used to produce exports?

For depreciation 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 the depreciation in the dollar's foreign exchange value. 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 3, which contains relative price data through the first half of 1987 (see the last column), shows that even though the foreign exchange value of the dollar has depreciated substantially against industrial country currencies, not much of the depreciation has been passed through to the relative price of imports. Since the relative price of imports has only recently begun to increase modestly, it shouldn't be too surprising to find that the consumption of imports in the US has gone unabated and the trade deficit has continued at record levels. To date, the price mechanism, working through changes in the value of the dollar, has not contributed to a significant adjustment in our trade balance. (Note that Chart 3 is an updated version of Chart 2 of the July 26, 1987 issue of *FC&CC*. Please see that issue for a full explanation of relative price of imports.)

* * * * *

Let's explore what is short-circuiting the price mechanism, so that we can determine whether the depreciation of the dollar can alone be relied upon to bring about an adjustment in the US trade balance. In principle, a depreciation of a home country's currency should result in an increase in the prices of imports and import substitutes produced domestically. This price increase should equal the full amount of the currency depreciation. In consequence of these price increases, the home country's consumption of actual imports and import substitutes produced domestically will decrease. The depreciation will also push domestic producers to use capacity liberated by reduced domestic consumption to produce exports, which foreigners will find more attractively priced after a home country's currency has been depreciated.

Now, this type of currency depreciation—with its reduction in the home country's consumption of imports and domestically-produced import substitutes and a shift of domestic production towards exports—will obviously reduce a trade deficit. Moreover, this classic result—where the price mechanism works to rapidly adjust a trade imbalance—can be obtained rather easily in cases where the home country whose currency is depreciating is a small, open economy in which the foreign trade sector is relatively large.

The trade adjustment can work rapidly in a small country with a large foreign trade sector because the increase in the price of imports and import substitutes produced domestically will cover a relatively large portion of the items consumed in the small country. Consequently, total domestic consumption (domestic purchasing power) will be hit rela-

tively hard by a devaluation and the consequent price increases. The resulting decrease in domestic consumption will be significant, therefore, and will free up domestic productive capacity. This capacity will be used to produce exports because exports can be profitably sold to foreign buyers who will find the prices attractive.

The US is a different and almost special case. It is a large, economy in which the foreign trade sector is a relatively small portion of the economy. As a result, the potential for a currency devaluation to cause a rapid adjustment is somewhat more limited because the depreciation will affect prices in only a relatively small portion of the economy and will, therefore, only modestly affect domestic purchasing power and consumption.

If this hindrance to rapid trade adjustment weren't enough, we must point out that even though the US trade sector is relatively small, it is large in absolute terms. Hence, changes in US import levels are very noticeable to those who export to the US. Since the US is such a large market, it is vitally important for foreign exporters to maintain their market shares in America. To accomplish this, foreign exporters have short-circuited the depreciation in the dollar by not fully passing through the appreciation in their currencies to the prices of the goods they export to the US (see Chart 3). Even though this has reduced foreign exporters' profit margins, it has allowed them to hold on to their US market shares. Without too much upward pressure on import prices, US producers of import substitutes haven't revised their prices that much.

As a result of the foreigners' short-circuiting the dollar's depreciation, the price mechanism hasn't done much to reduce our appetite for imports and/or import substitutes produced in the US. Hence, few domestic resources have been liberated, so that they can be used to increase US exports. To put it in other words, domestic spending in the US continues at a hot pace, and the economy pushes on capacity, with the percent of employed people over sixteen years of age at an all-time record level of 61.8%. Consequently, US producers, who produce goods that could be exported, are reluctant to export their output (even though profit margins have improved) because they can sell at a solid profit to reliable, long-time US customers.

We should also mention that export improvement has been slow because agricultural products, which are our largest export category, must compete with South America's (where currencies have actually depreciated relative to the US dollar) and the European Community's (where agricultural exports are subsidized). Hence, the dollar's overall depreciation has done little to stimulate this important export sector.

* * * * *

As we have argued, it is likely that changes in exchange rates will be short-circuited from time to time, and the effects of currency depreciation will be dulled and only slowly work through the economy. In consequence, the work of trade adjustment cannot be accomplished by depreciating the dollar alone. Hence, without changes in fiscal or monetary policy that are aimed at increasing net domestic financial savings, the trade deficit will remain large.

At present, we see little chance for a major modification in fiscal policy: Government spending will continue to grow in an unchecked fashion, and there will not be a significant tax increase until after President Reagan leaves the White House. This means that if there is a significant trade adjustment, it will come in the following form: With a continued ballooning of the trade gap, the dollar will remain under downward pressure and, indeed, will come under heavy attack once again; this will cause the Federal Reserve to come to the "rescue" by tightening monetary policy and increasing the discount rate once again; and this type of iterative process will continue to repeat itself, until the combination of a lower dollar coupled with a heavy dose of tight money (higher interest rates) has cooled the U.S. consumption (increased net domestic financial savings), so that a significant trade adjustment occurs.

To put it another way, a depreciating dollar hasn't been able to close the trade gap alone. Although further depreciation of the currency will go towards reducing the size of the trade deficit, the depreciation cannot be relied upon for the heavy gap-closing work that lies ahead. If the gap is to be closed, it will be monetary policy's heavy artillery that does the job.

—By Steve H. Hanke

Chart 2
Components of Net Domestic Financial Savings

(Billions of dollars) Year	Household[1]	Business[2]	Government[3]	Total
1978	- 19	11	0	- 8
1979	- 21	12	12	3
1980	14	27	- 35	6
1981	37	- 2	- 30	5
1982	49	61	-111	- 1
1983	- 22	112	-129	- 39
1984	- 13	26	-102	- 89
1985	- 49	75	-136	-110
1986	-103	97	-142	-148

Notes:
1: Excess (deficiency) of personal savings over residential investment.
2: Excess (deficiency) of business savings (including depreciation allowances) over business investment.
3: Excess (deficiency) of taxation (federal, state, and local) over government spending.

Chart 3
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%
II/1986 - II/1987	−12.9%	+ 1.4%

*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, combinig 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.

Interest Rate Futures

On Sept. 4, the Federal Reserve raised its discount rate to 6% from 5.5%, where it had stood since August 1986. The move merely confirmed the trend towards rising interest rates as three-month T-bills, on a coupon basis, were already trading close to 100 basis points higher. Witness to the dramatic steepening of the (positively sloped) yield curve that occurred during the past year was the fact that five-year Treasury securities were now yielding 300 basis points more than the discount rate (*after* the increase) compared with only 100 basis points at the end of August 1986.

While it would *appear* that *real* yields on Treasury securities are extremely attractive (9.75% yield on 30-year issues minus a current 4.5%-5% underlying rate of inflation, producing an approximate 5% real yield), the opposite is true; market yields carry an implicit forecast of substantially higher rates of inflation, a well-observed phenomenon in soft-currency countries.

The only event that could halt at this time the cyclical rise in interest rates (i.e., bulls' argument) is a recession. This is so because a recession would reduce the demand for credit and more importantly, would increase domestic savings. But, as we noted earlier, a recession is not yet imminent and is not likely to come about until inflationary pressures and interest rates rise far enough to choke the recovery. Ergo, the bond market must undergo a great deal more pain in coming months.

Technical readings reveal some support in the 78-80 area, which should equate with a 10%-10.5% yield on the underlying cash instrument. Once through this level, the market will find little support until it reaches the 13.5% area (1984 peak). Ultimately, the foreign exchange crisis that we foresee (see "Can the dollar do the job alone?") could push long-term Treasury yields well past the 1981-82 peak.

STRATEGY: *We advised* adding *to previously established short positions on a break below 87.25, basis September '87 (see Hotline Update, August 28). We have taken a very aggressive short position in T-bonds because we believe that the coming economic adjustment in the US will, inevitably, spell substantially higher interest rates.*

Chart 4 — CBT U.S. T-BONDS

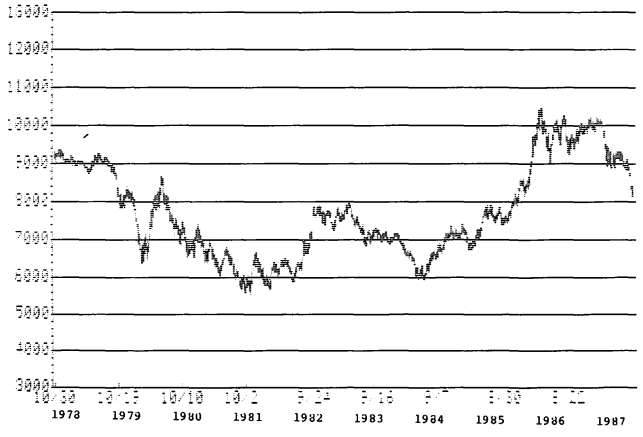
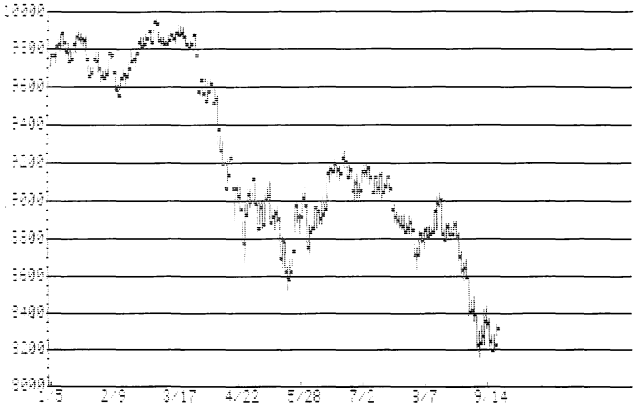


Chart 5 — CBT U.S. T-BONDS DEC 87



Stock Indexes

The most recent decline has been preceded and accompanied by the usual lethargy of negatives: Very poor breadth, a handful of stocks making new highs, a plurality of new lows over new highs, a Dow Jones Transport nonconfirmation, and so on. What is worse, a great deal of complacency has set in: In a week that saw a decline of all the major averages, weekly call option volumes on the S&P 100, S&P 500, and Amex Major Market exceeded weekly put option volumes.

Valuation yardsticks continue to flash red: Triple-A corporate bond yields now exceed earnings yields by more than 500 points compared with 200 points on the eve of the last major bear market (January 1973). Dividend yields of 2.7% on the Dow Jones Industrials, 2.8% on the S&P 500, and 2.36% on the S&P 400 have entered the area from which historic tops have been made. "Excess" liquidity (definition, please?) however, has overruled sanity. If one could only measure a change in the rate of change of this elusive liquidity concept, market tops and bottoms could easily be pinpointed. One such model, devised by Merrill Lynch Research Dept., compares the rate of growth of M3 versus nominal GNP (using Industrial Production and consumer prices as a proxy for nominal GNP): When the former exceeds the latter, liquidity is said to be expanding—being favorable for stock prices. And vice versa, when the latter exceeds the former, liquidity is contracting—being negative for stock prices. This simple model has anticipated (with a useful lead time) all major turning points in the US stock market since the early '60s (see Chart 6). Preliminary figures for last month, indicate that we

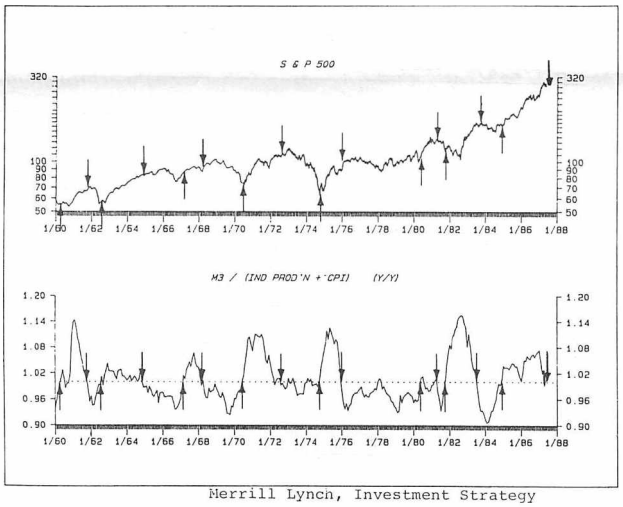
have entered a period of contracting liquidity. As a result, if history is any guide, a stock market top is near.

Our own liquidity analysis of the *Canadian* economy and its impact on the stock market (which parallel remarkably well the US markets) tend to support the view that we have entered a period of contracting liquidity, at least for financial markets. Chart 7 presents a summary of our mechanical buy/sell entries of the TSE 300 index based on a proprietary formula that uses Canadian banking data. A trading strategy based on this formula over the past 12 years would have generated five sell and four buy signals with a total return (if one were trading the index) of 545% compared with a 300% return on a single buy/hold strategy. Here, too, the model has flashed a sell signal which is still in force.

Technical considerations, when coupled with liquidity factors, overvaluation, and the ominous feeling of complacency add up to the *possibility* that this 7% plus "correction" may be, in fact, the beginning of the long-awaited bear market. Regardless of the near-term outcome, it is clear that the bull market is running out of time and money.

STRATEGY: *We are still trading the "beast" short-term, looking to establish a medium- to long-term position. (See Chart 10, based on Hotline Updates and Flash Recommendations.) We are currently short December '87 S&P as of September 18 at 318.50 with initial stops at 323.00, good anytime.*

Chart 6



Merrill Lynch, Investment Strategy

Chart 7

TSE 300 - Buy/Sell Signals based on Canadian Banking Data

	BUY	SELL	% P/L
Jun 75		1055.30	
Nov 76	920.10		+14.69%
Nov 76	920.10		
Dec 80		2268.70	+146.57%
Dec 80		2268.70	
Oct 82	1774.00		+ 27.89%
Oct 82	1774.00		
Dec 83		2552.40	+ 43.88%
Dec 83		2552.40	
Oct 85	2674.80		- 4.58%
Oct 85	2674.80		
Feb 86		2855.80	+ 6.77%
Feb 86		2855.80	
May 86	3122.00		- 8.53%
May 86	3122.00		
Jul 87		4030.00	+ 29.08%
Jul 87		4030.00	
Sep 18	3913.60		+ 2.97% **

% increase from Jun75 to Sep 87 = 544.53%

** unrealized at Sep 18 Closing Price.

Chart 8 — CME 500 STK. INDX.

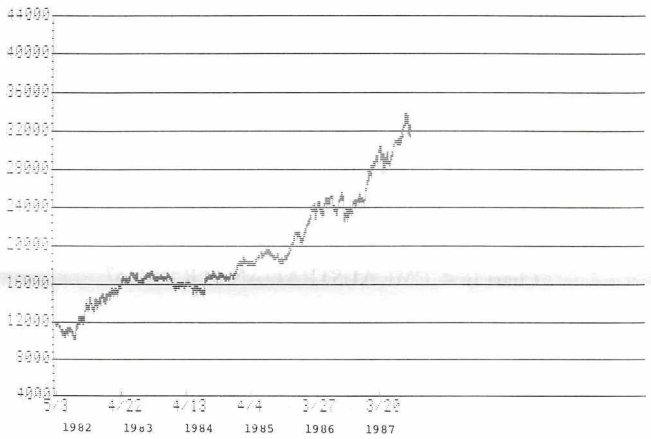


Chart 9 — CME S&P 500 INDEX

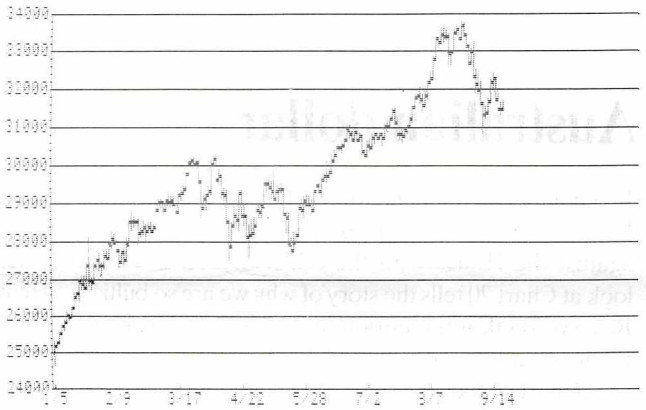


Chart 10

S&P

Date	Contract Month	Bot	Sold	Realized & unrealized P/L
6/26	Sep87		310.75	
7/16	Sep87	313.60		- 1,425
8/19	Sep87		328.70	
8/20	Sep87	334.45		- 2,875
8/28	Sep87		330.50	
9/11	Sep87	320.20		+ 5,150
9/14	Dec87		323.60	
9/15	Dec87	321.25		+ 1,175
9/18	Dec87		318.50	
9/18	Dec87	318.35		+ 75*
				+ 2,100

* Unrealized

Currencies

The worsening US trade figures will continue to put downward pressure on the US dollar. Ultimately, the fate of the dollar's *nominal* rate of exchange lies with the Fed: A permissive monetary policy oriented towards allowing the rate to find its "own level" will bring on a catastrophic drop of the dollar with no beneficial effects on the trade deficit, but with a dramatic impact on inflation. A firm (and, yes, tight) monetary policy designed to hold the dollar at the DM 1.80 and Yen 140 level will cause the correct "adjustment," improving the US trade account and calming eventually, the "spooked" bond market. In *real* terms, the US dollar has in all probability bottomed out, regardless of Fed action.

STRATEGY: *We "caught" a substantial upmove in the Yen (from 66.66 to 70.40, see Hotline Update) and DM and have since moved to the sidelines on the assumption that Fed Chairman Alan Greenspan is likely to "target" the DM/US parity at present levels, via rising interest rates. Keep in close contact.*

Chart 12 – CME JAPANESE YEN DEC 87

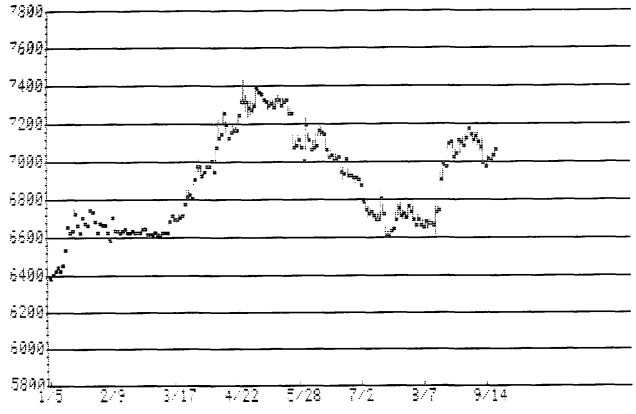
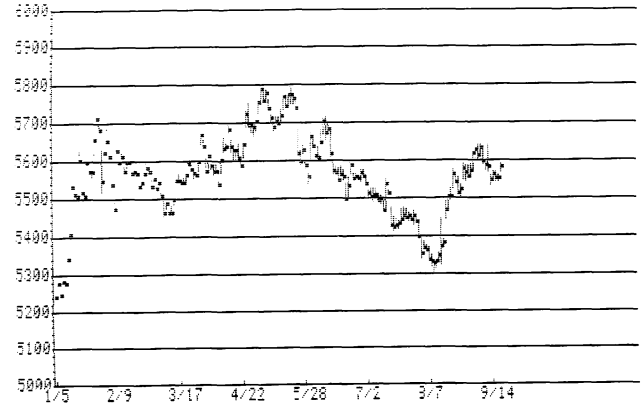


Chart 13 – CME DEUTSCHE MARK DEC 87



Australian dollar

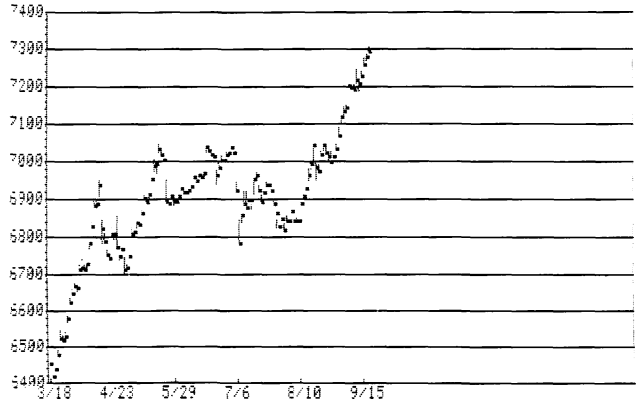
In our initial recommendation to buy the Aussie buck (*FC&CC*, June 24), we stated "an extraordinary opportunity to play against the House with the odds stacked in your favor... a look at Chart 20 tells the story of why we are so bullish... Heavy Reserve Bank intervention at 72.25-72.50 has been resisting the inevitable revaluation of the Aussie $."

Chart 16 tells the story of a successful speculation (albeit with a difficult moment as the Aussie buck reached lower in July and early August). International reserves have risen to a new high of $14 billion in a vain attempt to hold the currency pegged at 72.25; the reluctant withdrawal of the Reserve Bank allowed the spot to move up to 73.50. More is on the way.

Finance Minister Keating announced a budget surplus, terms of trade continue to move in Australia's favor, and the current account deficit is improving a great deal faster than anticipated. Down under is on the move.

STRATEGY: *Remain long; maintain stops at 71.50, basis December '87.*

Chart 16 – CME AUSTRALIAN DLR DEC 87



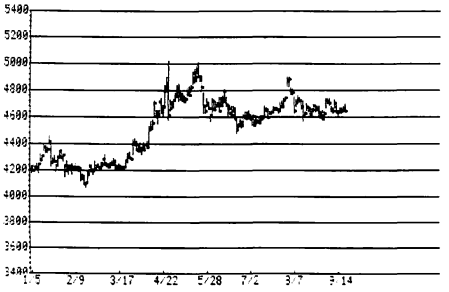
Precious Metals

Gold

Market continues to back and fill in a *narrowing* range, a sign of an impending major move. We have little doubt as to the direction of such a move: up, to challenge the all-time high of $825/oz.

STRATEGY: *Remain firmly and patiently long. Gold remains the single most preferred asset for capital appreciation. Short-term traders should retain stops at 455, basis December '87, close only.*

Chart 17 — COMEX GOLD DEC 87



Silver & Platinum

STRATEGY: *Remain long, maintaining stops at 710 and 580, basis nearest silver and platinum, respectively, on close only.*

Chart 18 — COMEX SILVER DEC 87

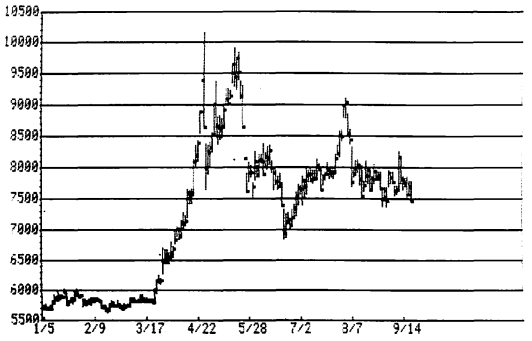
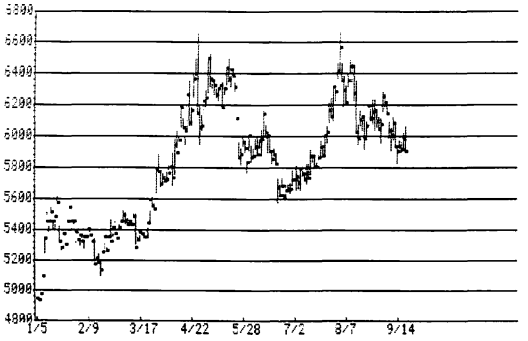


Chart 19 — NYME PLATINUM JAN 88

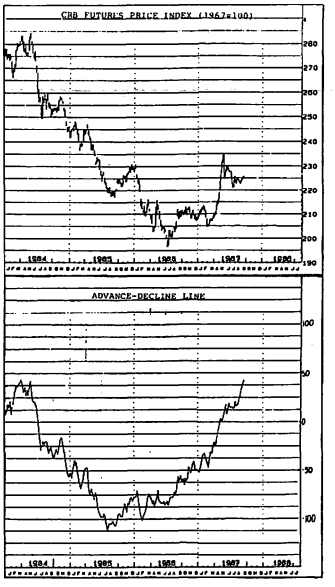


CRB Index

The sideways consolidation continues. The number of commodity markets firming on a weekly basis is on the rise, thus explaining the extraordinary strength of the advance/decline line (see Chart 20) This action presages an explosion in prices in the coming months.

STRATEGY: *Remain long, place stops at 219, basis the cash index, close only.*

Chart 20

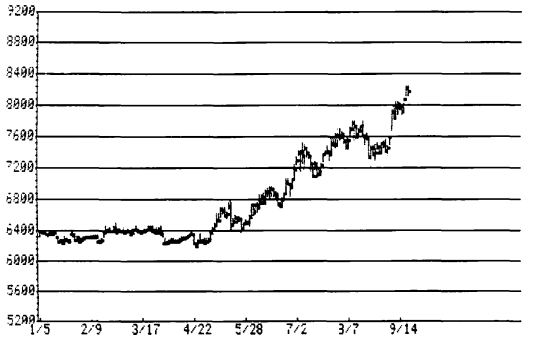


Copper

More than 2700 contracts remain outstanding in the spot September contract, days prior to expiration, helping copper make new multi-year highs—an unusual occurrence in the overall commodity spectrum.

STRATEGY: *On August 6, we advised liquidating long positions based on technical considerations. Subsequently the market suffered a 350-point correction. We were not nimble enough to benefit from this trading opportunity, thus missing this most dramatic rise to 84 cents. Look to reenter the long side on 250-point setbacks from any highs.*

Chart 21 — COMEX COPPER DEC 87



Free-fall dynamics, again?

"I was never taken by the idea that we would be rich forever."
—Minister Mohammed Ali Abalkhail,
Saudi Arabia

Last year's Opec agreement was cemented after some behind the scenes dealing between the Saudis and the Iranians. In exchange for the Iranians' promise to terminate their extramural activities during the annual pilgrimage to Mecca, the Saudis agreed to sack Sheikh Yamani and abandon his policy of increasing Saudi oil production, which was designed to lower prices, stimulate world oil demand, and increase the Saudis' dwindling share of the world market for crude.

To hold the new Opec accord together, the Saudis once again were forced to shoulder the burden inherent in any cartel agreement. Specifically, the Saudis had to operate as Opec's swing producer. This required the Kingdom to cut its production below quota levels, so that prices could be pushed up and the appearance of a successful agreement could be obtained. In consequence of the sacrifices made by the Saudis, as well as some saber-rattling in the Persian Gulf, oil prices shot up. At their peak, spot prices were almost $4 per barrel above the posted Opec prices.

These high prices were too tempting to resist. With their desperate need for cash, the Opec cheaters gradually began to come out of the closet. And, by late August, all members of Opec, except Ecuador (they are facing production problems as a result of an earthquake that damaged their pipeline facilities) were producing above their quotas. Not counting barter deals, total Opec production surged to a record 19.8 million barrels a day (b/d), which is almost 20% above the cartel's quota of 16.6 million b/d.

The Persian Gulf tanker war, of course, has played an important role in determining the market dynamics that allowed both production and prices to rise at the same time. On the demand side, the tanker war boosted the demand for inventories. As for the supply side, the threat of expanding hostilities put a "premium" on the Gulf oil that was actually shipped out of the region. This made expanded Gulf production more attractive. To put it in slightly more technical terms, the war has increased the implicit interest rates that the Gulf producers use to discount cash flows from oil sales (for a full analysis, see *FC&CC*, Feb. 15, 1987). In consequence of these higher interest rates, each dollar of future oil revenue is worth less than before rates increased, and it is, therefore, economic for producers to tilt their production away from the future and towards the present.

Although Opec's chairman, Mr. Rilwanu Lukman of Nigeria, refused to admit that Opec members were misbehaving, he called for emergency meetings of Opec's price stability committee and quota maintenance committee. These meetings were held in Vienna, and produced little more than jousting between Mr. Hossein Kazempour Ardebili, an uninvited guest from Iran, and Mr. Hisham Nazer, Saudi Arabia's oil minister. The Iranian deputy oil minister demanded that the Saudis operate as a swing producer and that they apply pressure on their allies—Kuwait, Iraq, and the United Arab Emirates—to rein in their "overproduction." Mr. Nazer responded by stating that all members of Opec should live by the cartel's accord (recall that, under the last Opec agreement, Iraq's production is exempt from the quota system) and that Saudi Arabia would, under no circumstances, prop up prices by operating as a swing producer. In consequence, the emergency meeting ended with a weak agreement: Mr. Lukman, along with the Indonesian and Venezuelan oil ministers, will visit the heads of state of all Opec nations to urge quota compliance.

* * * * *

So much for background. Now let's look at the current situation. To begin with, it is important to realize that moral suasion has never been an effective means to bring Opec cheaters to dock. At present, it appears that the task of bringing

about a collective cut-back of Opec production will be even more difficult than in the past because two of the biggest cheaters are Iran and Iraq, and they are not about to be denied the right to exceed their quotas. Iran desperately needs cash and is, shall we say, hard to handle; Iraq is exempt from the Opec accord and also needs more cash, which it plans to obtain shortly by cutting the ribbon on 500,000 barrels of new daily output. If Iran's and Iraq's production continues well above their quotas, other members of Opec, in order to hold prices up, would have to not only stop cheating but actually cut production below their quotas. Given their cash needs, this is not a very likely event.

Historically, the only proven method for stabilizing (or increasing) crude prices after an emergency Opec meeting has been the Saudis' willingness to cut their production and operate as a swing producer. Currently, however, there is virtually no prospect that the Saudis will assume their traditional role. First, there are politics. With the Mecca riots on July 31, the Iranians broke their end of the Saudi-Iranian detente that was instrumental in paving the way for last year's Opec accord. In response, and in an attempt to shed his "wimpy" image, King Fahd challenged Ayatollah Ruhollah Khomeini. As a result, the Kingdom can no longer be Opec's guardian angel. In fact, since the offensive use of the Kingdom's armed forces, without US support, can be virtually ruled out, the only real offensive weapon in the King's arsenal is oil. Hence, rather than swinging and cutting their production, the Saudis might very well decide to attack by increasing output to drive prices down.

The use of their oil weapon would also serve the Saudis' economic interests. Saudi Arabia has a great deal of excess capacity (4.5 million barrels a day, at current operating rates). Hence, if the Kingdom went to full production, which would double its output, its oil revenue would increase as long as the price stayed above about $10 per barrel. Moreover, the resulting low prices would stimulate world oil demand and make leverage work for, instead of against, the Saudis (for an analysis of leverage, see: *FC&CC*, May 24, 1987, and June 24, 1987). This would make it more economic for the Kingdom to develop its vast, cheap ($0.62 a barrel), known commercial oil fields (see *FC&CC*, May 18, 1986).

An increase in current output and development of known reserves (a tilting of output toward the present and away from the future) is desirable for the Saudis because the prospects for a "permanent oversupply" of oil and gas appear to be increasing with each passing day. For example, since we wrote about the huge discoveries of natural gas in the North Sea (see: *FC&CC*, April 26, 1987), there have been new developments. First, natural gas discoveries in the Amazon region of Brazil probably will double that country's gas reserves. Second, there have been an unexpectedly large number of new oil and gas finds in the North Sea this year, with the largest being a 350 million barrel field that was discovered by a team led by Kerr McGee. If this weren't enough, all members of Opec are pushing to increase their capacity because more capacity gives each a stronger hand in bargaining for a larger slice of any Opec pie.

The "permanent oversupply" of oil and gas has the following economic implications for the Saudis: It means that the real value (inflation apart) of each barrel of their vast reserves might fail or appreciate at a less rapid rate than the Saudis' real rate of interest used to discount cash flows (see: *FC&CC*, March 22, 1987). In consequence, it pays for the Saudis to liquidate their reserves today, rather than in the future.

Without the Saudis as the swing producer, the oil markets are in for some trouble. We can anticipate the coming troubles by observing inventory levels and the relationship between spot and Opec posted prices. At present, there are perhaps 50 unsold "cargoes" (27.5 million barrels) off the coast of Africa. In addition, August saw an unusually large build-up of inventories in Europe, with a large portion of those being in the Netherlands. These inventories overhang the spot market in Rotterdam, a market whose price has already swung from a premium to a discount *vis-a-vis* Opec posted prices. With this inventory overhang, spot prices will remain under downward pressure and continue to trade below Opec posted prices. In order to produce at quota or above (which they all want to do), Opec members will be forced to discount from posted prices. As this begins, the entire structure of prices will weaken. Whether prices will go into a free fall again will depend upon whether the Saudis decide to use their oil weapon. All we can say about this matter is that the political-economic rationale for them to move in the direction of unleashing production has strengthened over the past few months.

STRATEGY: *Remain short January 1988. Place stops at $19.60, close only.*

—By Steve H. Hanke

Friedberg Capital Markets

As every bond trader knows, there are two main considerations to trading fixed interest rate foreign currency bonds: interest rate risk and currency risk. But knowing and understanding are sometimes two different things.

The currency risk is easily understood: As the foreign currency strengthens against the base currency, the investor is better off. But the interest rate risk is a little more complex.

Bond prices move inversely with interest rates. That means that as interest rates rise, bondholders' principal is eroded, and the "yield to maturity" is affected.

But James Grant's *Interest Rate Observer* recently made some interesting arguments about yield to maturity. It contended that yield to maturity is nothing more than "forecast disguised as fact." The assumptions implied in the yield to

maturity on a fixed-rate bond are quite far-fetched if you think about it: first, that all the interest coupons are fully invested; second, that the coupon interest is reinvested at the original rate of interest. Even keeping this in mind, the yield to maturity doesn't incorporate compounding power (interest on interest) — which increases the annual total return to more than that advertised yield to maturity.

Of paramount importance to investors is to know which interest rate environment is best. Grant makes that case that higher rates often serve bondholders better than low ones because as coupons are paid, the holder benefits from reinvestment at higher rates. If this is true, both suppliers and users of funds (bondholders and bond issuers) can claim to be better off in any interest rate environment. Could this mean that the grass is greener wherever you are...?

Chart 22

Foreign Currency Bonds

DATE: September 15, 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%	102 1/4	-	103	15.71	16/6/87 -16/6/88
HONDA INT'L 20/9/89 16 3/8%	98 1/4	-	99	17.00	20/6/86 -20/9/87
HONDA INT'L 28/5/90 16%	98	-	93 3/4	16.32	28/11/86-28/5/88
TOURIST HOTEL CORP.(N.Z.) 4/6/93 zero coupon	44 5/8	-	45 3/8	14.87	matures 4/6/93
BANK OF NOVA SCOTIA 15/9/89 18½ RRSP eligible	103	-	103 3/4	16.13	15/9/87 -15/9/88
WELLS FARGO (semi-ann.) 12/5/89 16 1/8%	99	-	99 3/4	16.92	12/5/87 -12/11/87
KODAK (semi-ann.) 15/2/89 17%	101	-	101 3/4	16.12	15/8/87 -15/2/88
TORONTO DOMINION 2/4/90 18% RRSP eligible	103 1/4	-	104	15.79	2/4/87 - 2/4/88
AUSTRALIAN DOLLAR DENOMINATED BONDS					
CAN. IMP. BANK OF COMMERCE 13/3/91 13% RRSP eligible	101 3/4	-	102 1/2	12.01	13/3/87 -13/3/88
BRITISH POUND DENOMINATED BONDS					
TORONTO DOMINION BANK 20/5/92 9¼% RRSP eligible	94	-	94 3/4	10.71	20/5/87-20/5/88

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	-	100 3/4	6.48	19/6/87 - 19/6/88
GOVT. OF BELGIUM 29/4/96 5⅝%	90 1/2	-	91 1/4	6.87	29/4/87 - 29/4/88
QUEBEC HYDRO 1/5/96 5½ RRSP eligible	90 1/2	-	91 1/4	6.87	1/5/87 - 1/5/88
SWISS FRANC DENOMINATED BONDS					
GOVT. OF AUSTRALIA 30/10/98 5%	97 3/4	-	98 1/2	5.18	30/10/86 -30/10/87
JAPANESE YEN DENOMINATED BONDS					
GOVT. OF CANADA 23/7/93 5 5/8% RRSP eligible	99 1/8	-	99 7/8	5.65	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)	99.94-100.19		6 7/8%	7/10/87

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

Chart 23

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$, A$, BP) 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 September 15, 1987.**

	U.S. $	NEW ZEALAND $	AUSTRALIAN $	DEUTSCHEMARK	SWISS FRANC	JAPANESE YEN	BRITISH POUND
2 year	8.26%	Honda 16⅜ 20/9/89 yields 17.0% (.541 NZ/US)**					
3 year	8.60%	Toronto Dominion 18% 2/4/90 yields 15.79% (.522 NZ/US)					
4 year	8.76%		C.I.B.C. 13% 13/3/91 yields 12.01% (.648 A$/US)				Toronto Dominion 9¼% 20/5/92 yields 10.71% (1.53 BP/US)
6 year	9.09%	Tourist Hotel 0% 4/6/93 yields 14.87% (.464 NZ/US)				Canada 5⅝% 23/7/93 yields 5.65% (1.19 US/JY)	
7 year	9.24%			Portugal 6⅝% 19/6/94 yields 6.48% (1.42 US/DM)			
9 year	9.36%			Quebec Hydro 5½% 1/5/96 yields 6.87% (1.47 US/DM)			
11 year	9.44%				Australian 5% 30/10/98 yields 5.18% (.970 US/SF)		
Spot Exchange Rate	N/A	.633	.7297	1.813	1.5018	143.8	1.643

**For example, in parentheses, since a US$ based investor would receive 809 basis points (17.0% minus 8.26%) by holding the Honda bond, the NZ$ can depreciate to .541 NZ/US from the spot exchange rate of .633 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

Italian lira

Strong domestic growth coupled with an increasingly more overvalued lira have turned the trade figures. As an example, June imports by value were 18.7% higher than a year before; the non-oil trade balance has deteriorated by L6,000 billion in the first six months of 1987, the surplus falling to L182 billion. Thus the current account surplus for 1987 is likely to be only one third of the surplus registered in 1986. The economy is being propped up by strong credit growth (running 14%-15% more than the year before) and the incorrigible and monstrous fiscal deficit of around L120,000 billion, well over 11% of forecast GDP.

Recent pressure on the lira has prompted the central bank to limit credit extensions by the country's commercial banks. This measure, together with some restrictions in foreign exchange transactions that relate to imports, are likely to be successful in stemming a run on the lira for only a very short time. Fiscal policy remains the real Achilles heel: Italy's new government, following the general elections of June 14, is not likely to make a major dent in government spending.

STRATEGY: *We went long against the US$ on July 26, 1987, at 1340, basis spot, and advised liquidating on August 31 at 1313 spot. Look for a 5%-10% devaluation in the next EMS realignment; sell against DM, preferably six months forward or more, and remain neutral against the dollar.*

Chart 24

YEAR	ITALIAN LIRA PER U.S. DOLLAR (PERIOD)	U.S. 1970 =1.00	U.S. 1977 =1.00	BASKET 1970 =1.00	BASKET 1977 =1.00
				U.S. 13% Belgium 6%	
				U.K. 10% France 25%	
				Germany 31% Netherlands 8%	
				Switzerland 7%	
1967	624	0.9340	0.9939	0.9828	0.8358
1968	623	0.9569	1.0182	0.9586	0.8152
1969	627	0.9920	1.0556	0.9856	0.8382
1970	627	1.0000	1.0641	1.0000	0.8505
1971	618	0.9779	1.0406	1.0194	0.8669
1972	583	0.9039	0.9619	1.0069	0.8564
1973	583	0.8649	0.9203	1.0470	0.8905
1974	650	0.8995	0.9572	1.0858	0.9235
1975	652	0.8432	0.8972	1.0728	0.9124
1976	832	0.9734	1.0358	1.1789	1.0026
1977	882	0.9397	1.0000	1.1758	1.0000
1978	848	0.8671	0.9227	1.1832	1.0062
1979	830	0.8230	0.8758	1.1786	1.0024
1980	856	0.7943	0.8453	1.1560	0.9831
1981	1136	0.9740	1.0366	1.2194	1.0370
1982	1352	1.0553	1.1230	1.2221	1.0393
1983	1518	1.0678	1.1363	1.1565	0.9836
1984	1757	1.1623	1.2369	1.1517	0.9795
1985	1909	1.1975	1.2743	1.1654	0.9916
1986	1490	0.9009	0.9586	1.0324	0.8780
1987 (1Q)	1306	0.7810	0.8311	0.9728	0.8273

Above 1.00 = undervalued
below 1.00 = overvalued

Chart 25

Year	Foreign Assets (Mln US$)	CURRENT ACCOUNT As % of GNP	CUMULATIVE 12 QTR. Current Account (Mln US$)
1970	5,556	0.9	5996
1971	6,616	1.8	5347
1972	5,589	1.5	4934
1973	5,231	1.6	1494
1974	1,116	-4.7	8581
1975	964	-0.3	-11132
1976	4,228	-1.5	-11544
1977	9,016	1.1	-1041
1978	20,400	2.3	5776
1979	34,359	1.6	14091
1980	46,289	-2.5	1750
1981	39,340	-2.3	-12855
1982	30,884	-1.7	-24339
1983	37,517	0.4	-12931
1984	32,746	-0.3	- 5808
1985	27,068	-1.5	- 5383
1986	-	0.7	- 2461

Chart 26

HARD CURRENCY COVER (In millions of U.S. Dollars)
Reserves * + Previous 12-months curren Account ***= 54,523
(Reserves + 12-months C/A) /M1 ** = 54523/249300 = 21.8%
(Reserves + 12-months C/A)/ Broad Money ** = 54523/417007 = 13.1%
*As at June 1987 ** March 1986 *** 1987 Estimated

Figures in millions of U.S. Dollars

	M1 (Converted to U.S. Dollars)	Broad Money (Converted to U.S. Dollars)
1977	111,152	198,553
1987 March	249,300	417,007
% Increase (decrease)	124.3%	110.0%
Corresponding % increase in the United States	112.1%	111.7%

(a) 1986 Imports as percentage of GDP = 15.39%
(b) 1977 - 1986 Imports as percentage of GDP - 21.43
1986 /1977 - 1986 average) = (a)/(b) = 71.81%

Source: IFS

Chart 27 — Rates

Spot	1 Month	3 Month	6 Month	12 Month
1304 - 1305	1304- 1305	1306- 1307	1307- 1309	1310- 1312

Forex Rates & Update

Currency	*Spot*	*3-Month*	*12-Month*	*Comments vis à vis US$*	*Comments vis à vis DM (Spot DM: 1.8050)*
*Belgian franc	37.50-37.53	37.37-37.44	36.94-37.12	Neutral	Remain long
Danish krone	6.9565-6.9615	6.9830-6.9930	7.0615-7.0865	Neutral	Remain short
*Dutch guilder	2.0340-2.0350	2.0223-2.0238	1.9780-1.9810	Neutral	Remain long
Greek drachma	138.20-138.30	142.45-144.30	150.70-159.30	Remain short	Remain short
Hong Kong dollar	7.8000-7.8010	7.7760-7.7800	7.6950-7.7460	Sell 12 months at 7.65 to US if available	
Kuwaiti dinar	.28060-.28090	.27902-.27976	.27284-.27476	Neutral	Remain short
Malaysian ringgit	2.5190-2.5200	2.4890-2.4930	2.4440-2.4750	Neutral	Neutral
New Zealand dollar	.6390-.6400	.6220-.6240	.5815-.5875	Remain long	Remain long
Norwegian krone	6.6175-6.6225	6.7170-6.7260	6.9265-6.9410	Neutral	Neutral
Portugese escudo	142.10-142.50	144.35-146.75	149.60-160.00	Remain long	Neutral
Saudi Arabian riyal	3.7500-3.7510	3.7455-3.7485	3.7265-3.7320	Remain short	Remain short
Singapore dollar	2.0850-2.0865	2.0730-2.0750	2.0415-2.0465	Neutral	Neutral
*Swedish krona	6.3550-6.3600	6.3810-6.3900	6.4575-6.4720	Neutral	Neutral
Venezuelan bolivar	33.30-33.40	Not available	Not available	Commercial hedgers remain short	

Explanatory Notes

*Indicates change in recommendation from last issue

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

Hotline Update

Flash update, Thursday, July 30, 9:45 a.m.:
We apologize for having missed the regular Tuesday Hotline Update. The market letter was mailed Tuesday afternoon. We advised reentering the short side of the crude oil market and suggested a stop of 21.50, basis January, good anytime. Close out the short position this morning at the market, cancelling the aforementioned 21.50 stop, and remain sidelined.

Friday, July 31: There are no changes. We would like to repeat the flash of Thursday, July 30, 9:45 a.m.: Cover at the market short January crude oil positions, cancelling the 21.50 stop if you initiated a short sale earlier in the week as per our market letter.

Flash update, Monday, August 3, 12:05 p.m.: Sell January crude oil at the market. Place stops at 21.40, good anytime.

Tuesday, August 4: One new recommendation: As per our flash update of yesterday noon, you are now short January crude oil with a stop at 21.40, good anytime.

Flash update, Thursday, August 6, 9:45 a.m.: Liquidate long copper positions at the market, accepting handsome profits!

Friday, August 7: A recap of the week's activities: Two flash updates were issued.
1. On Monday, at noon, we recommended the sale of January crude oil with a stop at 21.40, good anytime.
2. On Thursday, at 9:45, we recommended the sale of long copper positions. No other changes or new recommendations.

Tuesday, August 11: No changes or new recommendations.

Flash update, Wednesday, August 12, 4:10 p.m.: In our last issue of *Commodity & Currency Comments*, we suggested buying September DM and September JY on closes above 5455 and 6730 respectively. Thus far, these buy stops have not been triggered. We would like, however, to anticipate this happening and advise buying *Japanese yen only* at the market. Place initial stops at 6490, close only. Retain buy stops in DM at 5465, close only, basis September.

Friday, August 14: As per our flash update of Wednesday at 4:10 p.m., you are now long December JY with a stop of 6490, close only. Retain buy stops in DM at 5465, basis September, close only.

Tuesday, August 18: No changes or new recommendations.

Flash update, Wednesday, August 19, 12:32 p.m.: Sell September S&P at the market, risking 338.00, good anytime. Stops will be tightened in the next few days.

Flash update, Thursday, August 20, 12:50 p.m.: Cover short September S&P positions, instituted yesterday at the market.

Friday, August 21: This is a complete review of all outstanding positions recommended in the market letter of July and modified by all updates until today.
1. You are long September CRB
2. You are long December gold with a stop at 455.00, close only
3. You are long both September silver and October platinum with stops at 669.00 and 550.00 respectively, good anytime.
4. You are short January crude as per our flash of August 3 at 12:05 p.m. at approximately 2105, with stops at 2140, good anytime.
5. You have liquidated long September copper positions as per our flash of Thursday, August 6, 9:45 p.m. at approximately 7670.
6. You are long September Australian dollar with stops at 6895.
7. You are short September T-bonds over 92.00 with a stop at 94.00, good anytime.
8. You are long December JY as per our flash of Wednesday, August 12, at 4:10 p.m. at approximately 6666 with a stop at 6490, close only.
9. You are long December DM as the September contract crossed 5465 on close.

Tuesday, August 25: No changes or new recommendations.

Flash update, Friday, August 28, 10:40 a.m.:
1. Sell long Yen positions accepting handsome profits.
2. Sell September S&P at the market, establishing new short positions. Place stops at 33600, good anytime.
3. Add to short positions in T-bonds on a close below 8725, basis September. Tighten stops on entire short T-bond position to 9116, basis September, good anytime.

No other new recommendations this week.

Flash update, Monday, August 31, 8:30 a.m.:
1. Liquidate long DM positions, accepting handsome profits. Accept profits and sell the following currency positions *vis à vis* the US$ only.
   a) Belgian franc
   b) Italian lira
   c) Spanish peseta
   d) Swedish krona

Tuesday, September 1: There were two changes made yesterday, August 31, at 8:30 a.m.:
1. Liquidate long DM positions, accepting profits.
2. Liquidate *vis à vis* the US$ only long positions in Belgian franc, Spanish peseta, Italian lira, and Swedish krona.

Friday, September 4: This is a review of our open positions with revised stops in some cases.
1. You are short December T-bonds. Lower stops to 8800, close only.
2. You are long September Australian dollar. Raise stops to 7150, good anytime.
3. You are short January crude oil. Lower stops to 1960, close only.
4. You are long December gold with a stop at 45500, close only.
5. You are long October platinum and September silver. Raise stops to 580.00 and 710.00, close only, respectively.
6. Tighten stops on short September S&P positions to 325.50, good anytime.
7. You are long September CRB
8. As per our flash of Monday, you have liquidated *vis à vis* the US dollar long Belgian franc, Spanish peseta, Italian lira, and Swedish krona positions. Also we have liquidated profitably long DM positions.

Tuesday, September 8: No changes or new recommendations.

Flash update, Friday, September 11, 11:00 a.m.: Cover short S&P positions at the market and stand aside.

Friday, September 11: As per our flash update this morning at 11:00 a.m., we have covered our short S&P positions. Stand aside.

Flash update, Monday, September 14, 2:25 p.m.: Sell December S&P at the market. Place initial stops at 32750, good anytime.

Flash update, Tuesday, September 15, 3:00 p.m.: Cover December S&P at the market.

Flash update, Friday, September 18, 1:05 p.m.: Sell December S&P. Place initial stops at 323.00, good anytime.

Friday, September 18: Lower stops on December short T-bonds to 8500, close only. As per our flash update, you are short December S&P with stops at 323.00, good anytime.

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