

FRIEDBERG'S

COMMODITY & CURRENCY COMMENTS

Friedberg Commodity Management Inc.



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The bubble is punctured

Rarely have so many remained so calm after so much devastation.

Reinforcing this sentiment, an activist Fed has let it be known that it will not spare liquidity. Short-term dollar interest rates have tumbled more than 200 basis points, long-term rates about half that amount. The Fed, it is said, has learned the lesson of the '30s, and it will not let it happen again.

We disagree. The prevailing complacency is based on a misconception. *We believe that the Fed has drawn the wrong conclusion about the 1929-33 episode, and as a result, it is likely to bring about an entirely different kind of economic Armageddon.*

But first, the facts. As related by Milton Friedman and Anna Schwartz in their monumental work *A Monetary History of the United States 1867-1960*, money supply declined 2.6% from the cyclical peak of August 1929 to October 1930, the onset of the first banking crisis. During this time, industrial production slumped 30% and personal income 18%. By way of comparison, industrial production dropped 28.2% from September 1974 to March 1975, 15.9% from January 1980 to July 1980, and 15.6% from July 1981 to December 1981. The contraction of August 1928 to October 1930 was severe, but it could hardly have been called a Great Depression.

It is also doubtful that the Fed could have staved off the initial adjustment; the growth of debt and speculation had outpaced economic reality and a liquidation of bad debts and investments seemed inevitable.

Where the Fed erred was from October 1930 to early 1933 as it failed to compensate for the multiple bank deposit liquidation that arose out of continued bank runs. Good loans and good banks were being liquidated in a vicious circle of falling liquidity. The extraordinary fall in the deposit-currency and the deposit-reserve ratios caused money supply to contract by close to 35% — an automatic and, perhaps, beneficial adjustment had turned into a rout.

Engineering a powerful reflating effort at the *commencement* of an economic decline or, even worse, at the first *sign* that it may start, is also a prescription for disaster, as attested by the 1980 episode. Selected credit controls on consumer purchases (a measure that was thought to soften inflationary

pressures) and the collapse of the stock market in early 1980 (and fears that the Hunt's silver fiasco and margin liquidation would force Bache & Co. into bankruptcy) caused the Fed to overreact and pump prime the monetary aggregates. Short-term interest rates collapsed (see Chart 1), debt deflation was stopped in its tracks, and the economy bounced back almost as quickly as it had fallen (see Chart 2).

For failure to allow "some pain" in the early stages, the Fed paid a heavy price: Inflation remained stubbornly high, and interest rates rebounded spectacularly rising to new highs (see Chart 1). Finally, the real economy peaked in July 1981 and declined into November 1982. The 1981-82 recession saw unemployment rise to 10.7%, a post-war peak. Clearly, an activist monetary policy was responsible for producing a roller coaster economic effect.

The lessons of a century of central banking are that the lender of last resort a) must provide liquidity to financial institutions in jeopardy against the collateralization of *sound* assets and b) it must not allow debt deflation caused by the closure of insolvent financial institutions to shrink money supply and endanger, through the lack of liquidity, solvent institutions. It should not assume that every financial collapse is an accident that requires its immediate attention. Rather, it should concentrate on seeing that the damage of the collapse does not spread into sound quarters.

This brings us to the week the bubble burst.

As we warned for months prior to last week, a "financial mania had gripped the world," (see, for instance, *FC&CC* March 22, 1987 — most of the quotes that follow are from that issue).

In this issue

Raging bulls? Yes... on gold that is. As for the stock market... well, we're humble, but comforted (a little) that the best gains lie ahead. We're on a new and dangerous inflationary course, and we're long copper. Also, the exotics and Friedberg Capital Markets. Contributions by Albert D. Friedberg, Steve H. Hanke, Michael D. Hart, and Daniel A. Gordon.

"... We are in the midst of a financial bubble. It cannot end well... When they begin to slide, governments will be unable to halt the slide. The immensely wealthy Kuwaiti government found this out, at great cost, after *their* financial bubble burst in the early '80s. How does it end? Mostly it just ends — with no specific reason to account for the break: Witness the unexplainable waves of selling that occurred in the September-October 1929 period. Technically, distribution (the movement of stock from strong to weak hands) is complete and the market falls, first on profit-taking and then in panic. The news, the events, follow the break and in retrospect make the crash more understandable.

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

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

"Rational investors, beware. Of the consequences."

These quotes are not repeated to blow our horn but to emphasize the irrationality of the global stock market boom that came to an end on October 19. As such, the Fed should welcome the collapse and allow the market mechanism, now restored to sanity, to work out the previous excesses, *even at the cost of a mild recession.*

It should be noted that, unlike 1929 (when the economy had already entered a recession two months prior to the crash — industrial production had declined at a 20% annual rate), 1974 (industrial production had been flat for over one year) and 1981 (the economy had been stalling since early 1979), the US economy in October 1987 has been in a vigorous expansion: Industrial production has been rising at an accelerating annual pace of 8.9% over the past three months and has risen 5.7% since September 1986, GNP grew at an annualized 3.8% rate in the third quarter, and unemployment has hit a seven and a half year low at 5.9%. This background provides

the Fed with an unusually favorable scenario in which to exercise a highly judicious monetary policy. It could even go a step further: Instead of declaring that everything is fine, it should publicly welcome the crash, admitting that we had experienced a financial bubble, which was unsustainable.

But there are far more powerful reasons why the Fed should not panic too soon. In the first place, the weak US dollar. As our colleague Steve H. Hanke discusses in "Snugging out, laxity in," the Fed and the Treasury cannot expect to defend target zones while there is even a perceived degree of monetary ease. In short, an active monetary policy is not compatible with semi-fixed rates of exchange. Should the Fed, however, decide to abandon target zones in favor of an expanding monetary policy, the US dollar is likely to fall substantially, threatening to reignite an acceleration of inflation and an eventual collapse of the bond market. Furthermore, commodities in general and the price of gold in particular are already displaying a very firm undertone — a sure sign that inflationary pressures are growing (see CRB and gold articles).

We summarize. The financial bubble has burst. It need not nor is it likely to lead to an immediate recession, especially in view of the upside momentum built into the economy at this time. Regardless, the Fed should not misread the lessons of history and attempt to stave off further losses in the financial arena: First, because that is not its function of lender of last resort; and second, because it merely postpones the inevitable economic adjustment. Moreover, currently the Fed has two powerful constraints working against *any* monetary accommodation: the falling dollar and rising commodity prices (especially gold). In fact, once *more orderly* conditions are restored (and we do not necessarily mean a rally), the Fed should concentrate on *tightening* monetary policy to induce a rise in savings (and a concomitant cure to the current account deficit) and a halt to the rise in commodity prices.

Betting men say that the Fed will equivocate and that interest rates will first dip and then rise, that the dollar will fall, that commodity inflation will soar, and that *eventually* the (postponed) great recession will anyway arrive.

Chart 1

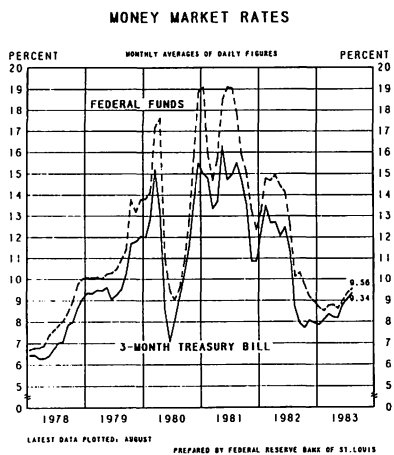
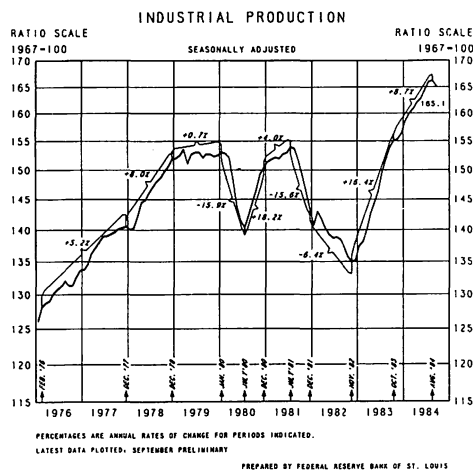


Chart 2



Gold

In the short span of one week, gold underwent three fundamentally different phases. In phase one, it reacted as a *safe haven*, rising as much as \$16/oz. on the very day the NYSE experienced the largest plunge in history. But, in a "normal" world, government obligations are a "better" safe haven, as they yield income, particularly with the looming spectre of depression. Down it went on Tuesday almost \$20/oz., reflecting new disenchantment with the safe haven concept and fear of a deflationary depression. By Wednesday, a statement by Fed Chairman Alan Greenspan that the Board would meet its responsibilities as the nation's central bank to serve as a source of liquidity to support the US economic and financial system dispelled the fears of deflation and awoke the fear of inflation. Significantly, gold ended higher on the week, an omen that inflation, not deflation, is the real danger.

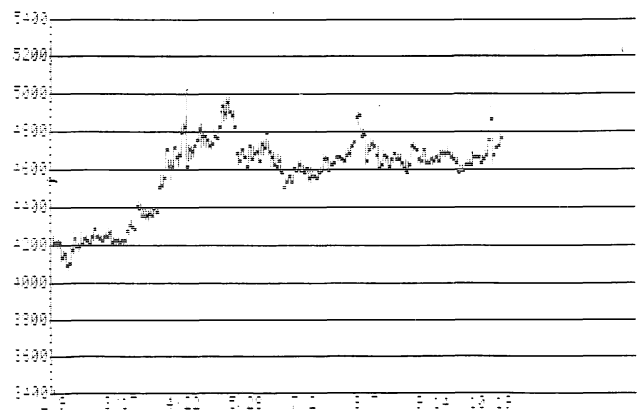
The six-month base is nearly complete. The extremely low open interest level indicates a deeply oversold condition. Public apathy was joined by professional complacency: Until Monday, option premiums had dwindled to less than half their March/April levels.

Sentiment, reinforced by discussions of sharply rising production and low CPI figures (0.2% in September) is downright bearish. And yet, prices remain well perched above \$455-\$460/oz. No doubt some powerful and quiet buying is

taking place at these levels, based on the conviction (ours too, as it happens) that gold will be the safest, most liquid, and most profitable asset to own in the months and years ahead.

STRATEGY: *We added to long positions on Tuesday (over the Hotline Update), leaving stops at 455, basis December '87, close only. We are raging bulls.*

Chart 3 — COMEX GOLD DEC 87



Silver & Platinum

STRATEGY: *Remain long silver, maintaining stops at 710, basis nearby contract. We have been stopped out of platinum, on a close below 580. We continue to believe that gold offers the best prospects for the precious metals.*

Chart 4 — COMEX SILVER DEC 87

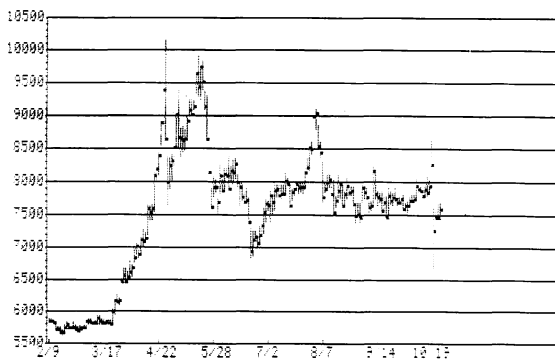
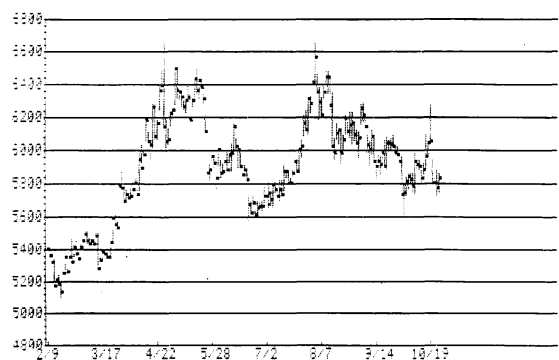


Chart 5 — NYME PLATINUM JAN 88



Stock Indexes

After advancing the view, last month, that a "stock market top is near" based on technical consideration, liquidity factors, overvaluation, and the ominous feeling of complacency (allowing for the *possibility* that the continuing 7% plus correction was in fact the beginning of the long-awaited bear

market), we were left standing at the gate. Two attempts to sell index futures were stopped out due to sharp countertrend rallies and the market's extreme volatility. We were forced to watch the debacle, as spectators, consoled by the (poor) comfort of knowing that we had entered a long bear market —

and that, in fact, the best gains lie ahead.

We concluded last month that the bull market was "running out of time and money!" Of course, it can always be replenished with money if the Fed so orders it, and, perhaps, a partial attempt will be made to increase liquidity. If so, the market can regain a substantial amount of the losses, perhaps recovering to the 2300 level in the Dow Jones Industrials and to the 280-290 in the S&P 500. Militating against a more substantial recovery are two facts: 1) The dollar and inflation constraints (see first article) will put a lid on the Fed's efforts to reflate; and 2) on a valuation basis, the market still remains fully priced, at best (and more so, of course, if it recovered to Dow 2300).

The lows of this week are likely to hold for some time, but the odds are that we have entered a long bear market.

STRATEGY: Stand aside for now.

Chart 6 — CME 500 STK. INDX. DEC 87

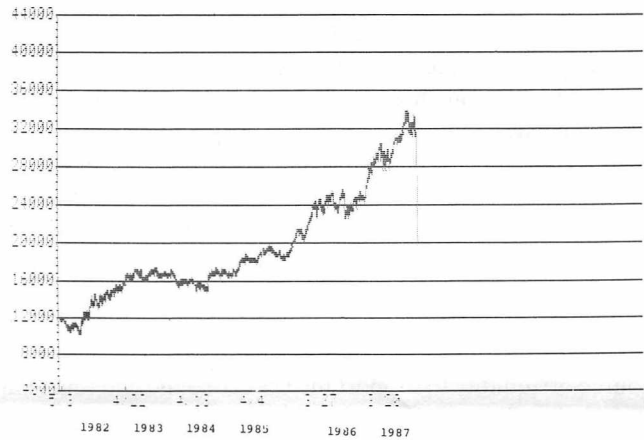


Chart 7 — CME S&P 500 INDEX NOV 87

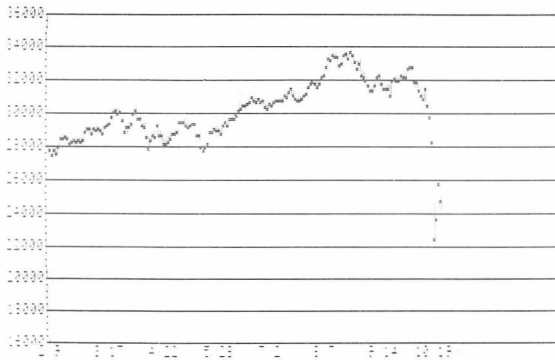
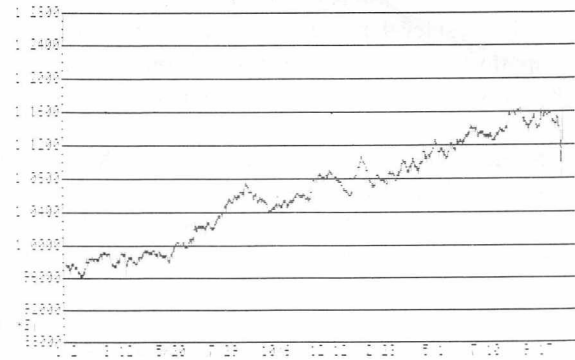


Chart 8 — S&P 500/VALUE LINE



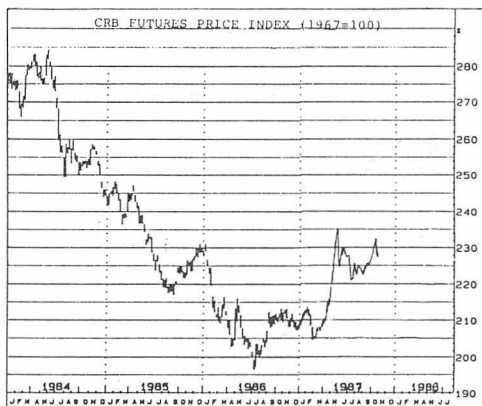
CRB Index

Huge forward discounts and heavy price open interest liquidation tell us that bearish sentiment is overdone.

An examination of the market's breadth (see Chart 9) leaves us satisfied that the commodity bull trend is still intact and likely to accelerate on the upside. So much for all the talk of deflation.

STRATEGY: We added, on Tuesday, to our CRB position, taking advantage of the severe setback and the inordinate forward discounts. Maintain stops at 219.00, basis the cash index, close only.

Chart 9



Snuggling out, laxity in

In the last two issues of *Friedberg's Commodity & Currency Comments* (July 26, 1987 and Sept. 20, 1987), we concluded that the US balance of merchandise trade would not show a significant improvement in the near future. Hence, we were not surprised on Oct. 14, 1987, when the US Commerce Department announced that the August trade deficit (\$15.7 billion) was almost as large as July's all-time record deficit (\$16.5 million). We were, of course, somewhat surprised that the August trade deficit would provide the major catalyst for the market chaos that ensued.

The balance of merchandise trade is the most important component of the current account, with trade in services and unilateral transfers (gifts) making up the remainder. When the current account is in deficit, as it is now, we know that net domestic financial savings are in deficit (that is, domestic saving is less than domestic investment). We also know that this deficit must be filled by importing foreign capital. To put it another way, foreign capital flows into the US, so that the current account deficit can be financed. Hence, foreigners' future claims on US assets (either debt or ownership claims) must increase.

These basic relationships lead to the following fundamental question: Is the current course of our financial affairs sustainable?

* * * * *

Before we answer this question, we must recall that there are three basic mechanisms that can alter the course of (reduce) our current account deficit and, hence, our capital import needs. The first adjustment mechanism is foreign exchange rates. In principle, here is how this mechanism should work. A devaluation of the dollar should result in an increase in the prices of US imports and import substitutes produced in the US. These price increases should equal the full amount of the dollar devaluation. In consequence of these price increases, our consumption of actual imports and import substitutes produced domestically should decrease. Also, the devaluation should reduce our purchasing power, and hence, our consumption of all other goods and services should decrease. As a result of the changes in relative import prices and reductions in our purchasing power, our imports should fall, some of our productive capacity should be freed up, and this excess capacity should be used to produce increased exports because foreigners should find our goods relatively cheap. In the end, these shifts from imports to exports should reduce our trade deficit and, hence, our need to import foreign capital.

The second adjustment mechanism is fiscal policy. In principle, here is how it should work. By tightening fiscal policy (reducing government spending, increasing taxes, or some combination of both), net domestic financial savings should be increased (for details, see *FC&CC* Sept. 20, 1987). For example, tighter fiscal policy will directly reduce the govern-

ment budget deficit, and this will increase net domestic financial savings. It could also act to reduce residential and business investment, which would increase net domestic financial savings. Hence, a tighter fiscal policy should act to reduce our need to import foreign capital.

The third adjustment mechanism is monetary policy. In principle, here is how it should work. A tighter monetary policy should increase household savings and, at the same time, reduce residential and business investment. In consequence, a tighter monetary policy should increase net domestic financial savings and reduce our need to import foreign capital.

* * * * *

To analyze the basic question of sustainability, assume that current exchange rates remain in their so-called target zones, that fiscal policy remains unchanged, and that monetary policy remains unchanged. With this strict set of assumptions, the US current account would remain in deficit, the US would continue to import foreign capital, and the US would continue to pile up external debt and interest obligations. As long as the rate of interest on external debt continues to exceed the rate of growth in the US economy, the US external debt would grow relative to our ability to repay (gross domestic product).

This course could not be sustained. Even the US could not increase its external borrowing forever. The nation would ultimately hit a "limit" on the amount of foreign capital imports that it could feasibly finance. In consequence, there must be an adjustment to reduce our current account deficit, increase our net domestic financial savings, and reduce our foreign capital needs.

* * * * *

The need for economic adjustment has been realized for some time. However, as we have repeatedly warned, the steps that have been taken to insure a smooth adjustment have been either improper or inadequate. In consequence, the required adjustment has not been forthcoming.

The first attempt at adjustment came in February 1985, with the so-called Plaza Accord. This accord put into place policies that would allow the dollar to be devalued. As a result, the effective dollar exchange rate has been reduced by more than 38%. However, this devaluation has not worked to reduce the current account deficit because relative import prices have increased only by less than 1.5%. In short, the foreign exchange adjustment mechanism has been short-circuited (for details, see *FC&CC* Sept. 20, 1987).

Since a devalued dollar was not and could not accomplish the adjustment in our current account deficit alone and since policy makers became worried that a further decline in the value of the dollar would result in excessive inflation, the exchange rate mechanism was switched off in March 1987.

At that time, officials from the major trading nations announced that they had "agreed to cooperate closely to foster stability of exchange rates around current levels." This move to so-called currency target zones halted the dollar's fall because foreign central banks began to intervene in foreign exchange markets by purchasing dollars and dollar-denominated assets (US Treasury bills and bonds). In consequence of their massive interventions, the major central banks began, in large part, to finance our current account deficit by exporting official reserves to the US. Although intervention helped to finance our current account deficit, it also neutralized the exchange rate adjustment mechanism.

With the exchange rate mechanism turned off, the only means for attaining adjustment were tighter fiscal and monetary policies. Although both began to tighten and move in the proper direction, the magnitude of the tightening was much too slight to invoke the necessary adjustment. This is evidenced by the fact that the real economy is roaring at near-boom conditions and the deficit in net domestic financial savings, which must be filled by the importation of foreign capital, continues at record levels.

* * * * *

With no adjustments in sight, and another dismal trade deficit number, the markets were thrown into total chaos. Let's examine what the events of last week hold in store for the sustainability of our current policy course.

The markets sent the politicians in Washington, D.C. scurrying about in wild finger-pointing exercises. It appears that, when these fits of irresponsibility come to a halt, the Reagan Administration and the Congress will do little more than meet the budget deficit reduction targets to which they have already agreed. If this can be accomplished, it will not be an extraordinary performance because fiscal policy will remain extremely loose, with the annual federal budget deficit still running about \$150 billion. Hence, the needed adjustment in the net domestic financial savings deficit will receive, at best, little help from tighter fiscal policy.

While it appears that the events of last week hold out little hope for a significant change in fiscal policy, they have already forced a dramatic change in monetary policy. Last Monday, the Federal Reserve Board threw its "snugging pol-

icy" out the window and replaced it with a "laxity policy." In an attempt to avoid anything approaching the chaos of last week, the Fed will continue to bias its policies toward a lax monetary policy. In consequence, this new monetary stance will actually act to aggravate, rather than correct, our current account deficit problem.

Given that the pain of a significantly tighter fiscal policy or even a "snugging" monetary policy appears to be beyond the threshold that can be endured by our politicians, it appears that the only adjustment mechanisms left in Washington, D.C. will, once again, be foreign exchange rates. With a looser monetary policy, the present currency target zones cannot be sustained. They will have to be reestablished, with a lower valued dollar. While a lower valued dollar might assist the current account adjustment process, it cannot, as we have repeatedly warned, do the adjusting alone (see *FC&CC* Sept. 20, 1987). Moreover, by abandoning the hard options (tighter fiscal and monetary policy) and embracing the soft option (a devalued dollar), our politicians promise to set us on a new and dangerous inflationary course (see "Dollar Down, Inflation Up" in *FC&CC* Dec. 14, 1986).

STRATEGY: You are long as per Hotline Update, Friday, Oct. 23, DEC. '87 Yen, Dec. '87 DM, and Dec. '87 SF. Place stops at 69.32, 55.00, and 66.40, respectively, good anytime.

— By Steve H. Hanke

Chart 10 — CME DEUTSCHE MARK DEC 87

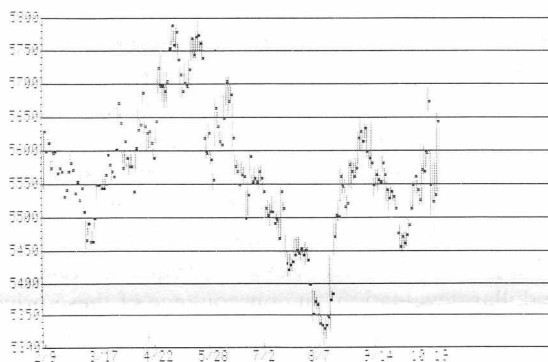


Chart 11 — CME SWISS FRANCS DEC 87

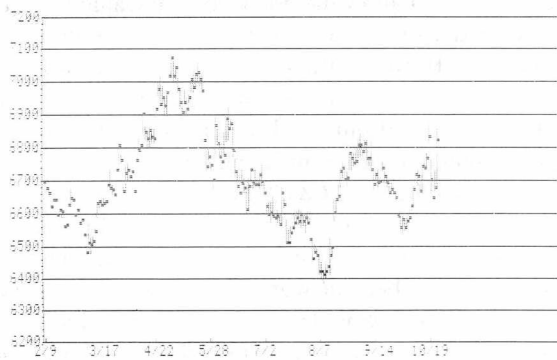
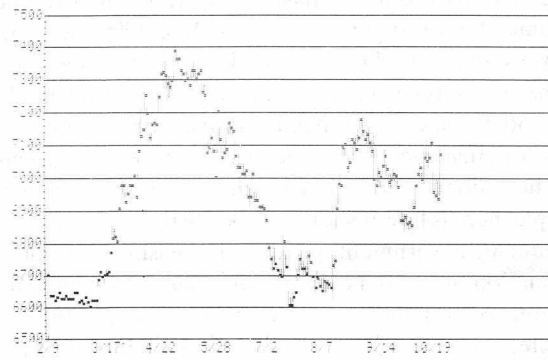


Chart 12 — CME JAPANESE YEN DEC 87



Interest Rate Futures

A sudden realization that the stock market crash meant 1) that bonds were, after all, more attractive than stocks (on a return basis), 2) bonds were ideal to hold during the coming deflation/depression, and 3) that the Fed would ease aggressively ignited a powerful short-covering rally. Option traders, caught off balance, reinforced the thrust that saw prices touch 88½ in LIFFE trading, a mere 24 hours after prices hit a 76.08 low. Cooler spirits and some profit taking brought prices back to the low 83 area, at which point we concluded that prudence was the better part of valor and accepted substantial profits on our outstanding short positions (see Hotline Update). Through the end of the week, prices had made a second thrust towards the 89 level, to settle back on Friday at 86.18.

Is this move the beginning of a bull market? Our answer is an unqualified no. The bear market argument can be summarized as follows: a) Commodity prices are firm and rising, a sure sign that inflation is on the rise; b) the dollar remains under pressure, making bonds unattractive to foreign holders, c) the basic savings/investment imbalance, which is caus-

ing a current account deficit, persists and is not likely to be redressed until interest rates are substantially higher (see "Snugging out, laxity in" for a fuller discussion).

STRATEGY: *Having covered our short positions around 83, we have moved to the sidelines, awaiting signs that the rally has run its course. Keep in close contact.*

Chart 13 — T-BONDS (DAY) DEC 87

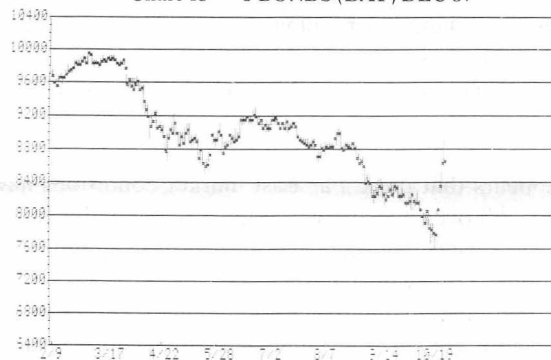
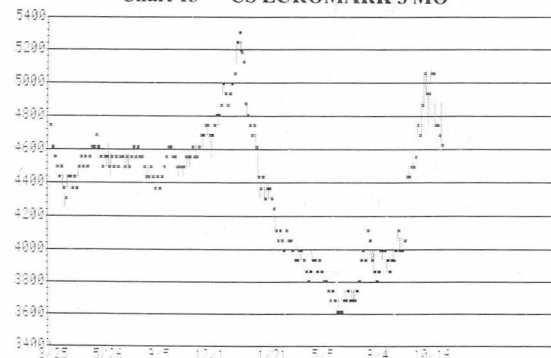


Chart 14 — CS EURODOLLAR 3 MO



Chart 15 — CS EUROMARK 3 MO



Copper

In just the first two days of this week, copper prices retraced all the gains made since mid-August, falling an incredible 1700 points. Once again, fears of a deflationary depression caused massive liquidation, primarily among professionals.

On Tuesday, around midday, we advised purchasing copper futures (see Hotline Update), then down around 900 points on the day, on the basis that a depression was not likely to develop in time to relieve the tightness of near-term supplies. As the week wore on, the backwardation widened, confirming our suspicion that high-grade copper for immediate delivery is in very short supply.

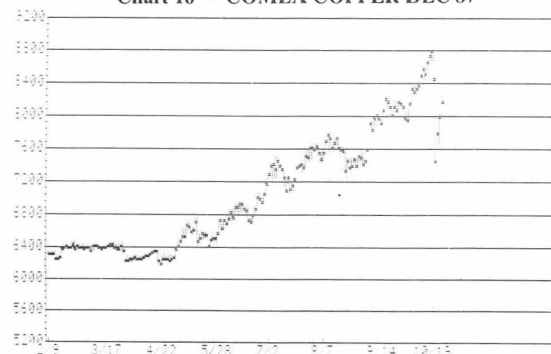
Copper prices are an ideal barometer of industrial conditions. If the market remains locked in a 80-90 cent/lb. range, it will mean that the economy has weathered the storm and more growth is ahead. A close below 72 cent/lb., on the other hand, would signal the onset of a recession. In our opinion, the Fed is likely to overreact and copper will rise to new recovery highs in very short order. This event will signal a surge

of inflation ahead and rapidly rising interest rates.

Copper, along with gold but even more so, has become our economic fair-weather vane.

STRATEGY: *Remain long, leaving stops at 76.00, close only, basis December '87.*

Chart 16 — COMEX COPPER DEC 87



Sugar: a bit sweeter

For those who have followed our recent analyses of sugar, you will note that we have gone from sweet to sour (see *FC&CC* May 24, 1987, and July 26, 1987). We have recently become more friendly to this market and are sweet again.

Three factors have altered our thinking; two are fundamental and one is technical. On the fundamental side, there is a current deficit of sugar in the Far East. This is the result of increased consumption in China and other developing Asian countries, as well as stagnant or declining output from traditional exporters in the region (Fiji, the Philippines, Taiwan, and Thailand). In consequence, sugar stocks in the Far East are declining rapidly and there is backwardation in that market. It appears that these Far East market conditions have started to spill over into the world market. By pulling sugar into the Far Eastern market, that market has begun to lend some support to the world market.

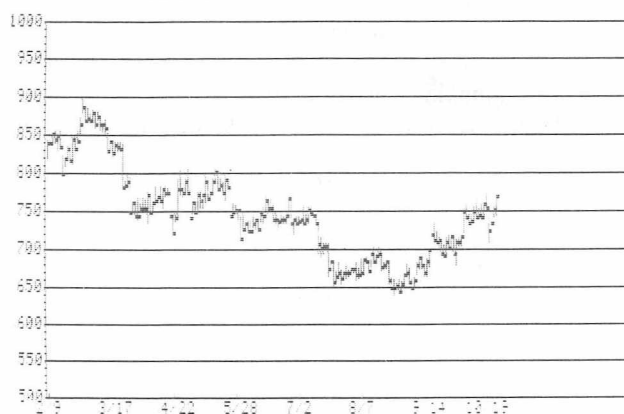
The second fundamental factor that has recently altered our thinking is the prospect that sugar production and exports from the European Economic Community (EEC) will be lower than previously anticipated. It now appears that the EEC, which is the world's largest exporter, will have to cut its 1987-88 export volume to 4.0 million tons from 5.3 million tons (25% reduction). In addition, poor growing and harvesting conditions are projected to reduce the Soviet Union's production by 5.8% from last year's levels.

Technical factors also signal new strength in sugar. For example, sugar weathered last week's market chaos rather

well. Moreover, open interest in the March contract reached a recent high of 107,037 contracts at a price of 7.51 cents per pound on Oct. 12, 1987. On Oct. 22, 1987, the open interest had fallen to 93,508 contracts and the price was holding at 7.52 cents per pound. This implies that the outstanding contracts are now in somewhat stronger hands than they were. This, along with the fundamentals, has turned us sweet on sugar.

STRATEGY: Buy March '87 sugar; place initial stops at 7.05, close only.

Chart 17 — N.Y. #11 SUGAR MAR 88



Crude Oil

STRATEGY: Stopped out (with a small profit) at around 1960, basis January 1988, as per last month's comments. Stand aside for the moment. In the weeks ahead we will probe once again the short side. Keep in close contact.

Chart 18

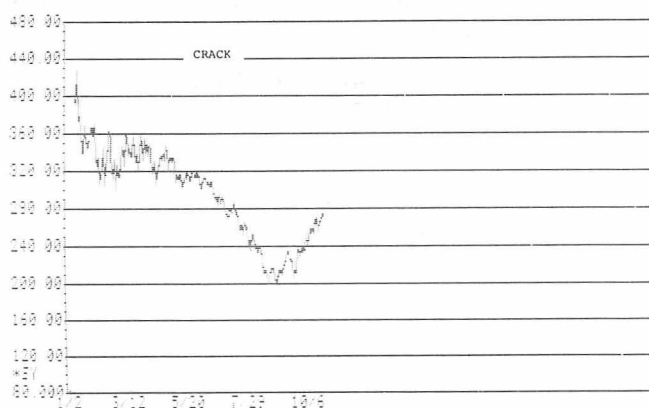
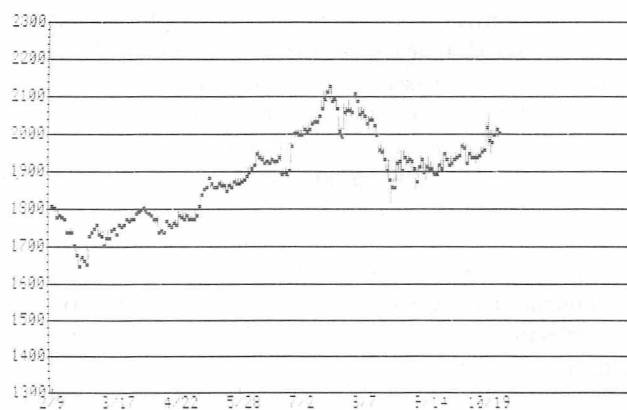


Chart 19 — NYME CRUDE LIGHT JAN 88

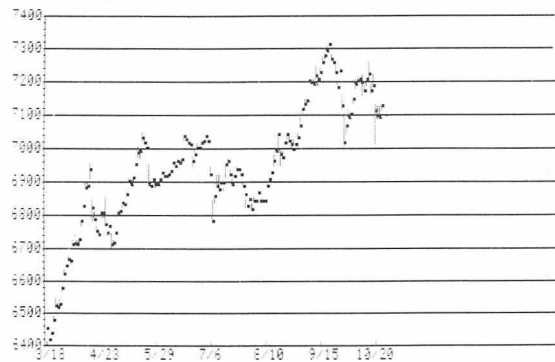


Currencies

Australian dollar

STRATEGY: Stopped out at 7150, as per last month's advice, accepting handsome profits. Stand aside.

Chart 20 — CME AUSTRALIAN DLR DEC 87



The Exotics

Spanish peseta

Shortly after joining the EEC, the Spanish government embarked on a liberalization and deregulation program that in effect facilitated the country's integration into the common market.

Two important effects were the convergence of its inflation rate down to the EEC's level (although not quite achieving it yet) and the surge of foreign investment. This latter effect has created a number of problems in monetary control, causing continuous upward pressure on the peseta and an inordinate expansion of domestic money and credit. This in turn brought about a booming consumer demand and consequently a serious deterioration in the trade balance. In an attempt to counter easy monetary and credit conditions, the central bank raised call money rates to above 19% in May

1987 (since then, they have fallen slightly).

The surge of foreign investment will continue to put upward pressure on the currency, necessitating an ever larger trade deficit. These one-time effects are *real* and not the consequence of monetary and/or fiscal policies, which stand defenseless in an attempt to alter the exchange rate and/or monetary variables. The best thing the government can do is to remove as many rigidities as possible from their labor sector while liberalizing imports from non-EEC sources, if at all possible.

STRATEGY: We went long against the US dollar July 26, 1987, at 127.00, basis spot, and advised liquidation on August 31 at 122.15 spot. During this period, we also earned 0.8% on the forward rate. Buy pesetas against US dollars and remain neutral against the deutsche mark.

Chart 21

YEAR	SPANISH PESETAS PER: U.S. DOLLAR (PERIOD)	U.S.		BASKET	
		1970 =1.00	1978 =1.00	1970 =1.00	1978 =1.00
1967	61.08	0.8538	1.3978	0.9033	1.1384
1968	69.68	0.9661	1.5817	0.9665	1.2181
1969	69.85	0.9994	1.6363	0.9951	1.2542
1970	69.70	1.0000	1.6372	1.0000	1.2603
1971	69.23	0.9579	1.5683	0.9974	1.2571
1972	64.27	0.8471	1.3868	0.9359	1.1795
1973	58.26	0.7315	1.1976	0.8589	1.0824
1974	57.69	0.6959	1.1393	0.8137	1.0255
1975	57.41	0.6469	1.0592	0.7958	1.0030
1976	66.90	0.6929	1.1344	0.8072	1.0173
1977	75.96	0.6730	1.1019	0.8121	1.0235
1978	76.67	0.6108	1.0000	0.7934	1.0000
1979	67.13	0.5144	0.8422	0.7069	0.8909
1980	71.70	0.5395	0.8832	0.7688	0.9690
1981	92.32	0.6697	1.0965	0.8337	1.0508
1982	109.86	0.7389	1.2097	0.8492	1.0703
1983	143.43	0.8875	1.4531	0.9488	1.1958
1984	160.76	0.9323	1.5264	0.9167	1.1554
1985	170.04	0.9380	1.5357	0.9102	1.1472
1986	140.05	0.7244	1.1861	0.8082	1.0186
1987 (1Q)	128.97	0.6545	1.0715	0.7829	0.9867

----- BASKET -----
 U.S. 17% Italy 13%
 U.K. 14% France 25%
 Germany 24% Netherlands 7%

Above 1.00 = undervalued
 Below 1.00 = overvalued

Chart 22

Year	Foreign Assets (Min US\$)	CURRENT ACCOUNT As % of GNP	CUMULATIVE 12 QTR. Current Account (Min US\$)
1970	1520	0.2	-510
1971	2969	2.0	543
1972	4436	1.1	1516
1973	6110	0.8	2022
1974	4402	-3.6	-2067
1975	2509	-3.3	-6126
1976	-146	-4.0	-11039
1977	-395	-1.7	-9939
1978	3551	1.1	-4791
1979	5275	0.6	629
1980	1097	-2.4	-2411
1981	1097	-2.7	-9034
1982	595	-2.3	-14407
1983	-4347	-1.7	-11780
1984	8396	1.3	-4973
1985	10812	1.7	2123
1986	13119	4.1	9129

Chart 23

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

Reserves * + Previous 12-months current Account *** = 26,828
 (Reserves + 12-months C/A) / M1 ** = 26828/57739 = 46.5%
 (Reserves + 12-months C/A) / Broad Money ** = 26828/172106 = 15.5%

* As at May 1987 ** May 1987 *** 1987 Estimated

Figures in millions of U.S. Dollars

	M1 (Converted to U.S. Dollars)	Broad Money (Converted to U.S. Dollars)
1977	35051	91,966
1987 May	57739	172,106
% Increase (decrease)	64.7%	87.1%
Corresponding % increase in the United States	116.7	113.2

(a) 1985 Imports as percentage of GNP 16.7%
 (b) 1976 - 1985 Imports as percentage of GNP 13.5%
 1985 / 1976 - 1985 average = (a)/(b) = 123.47%

Source: IFS

Friedberg Capital Markets

A number of variables govern the basics of investing in bonds. However, investors rarely are concerned with the component parts of bond theory. The single most significant factor for investors, great and small, is total return. Total return is defined as the net gain (or loss) due to the price of the bond plus the net gain due to coupon interest plus the net gain (or loss) due to the currency appreciation all expressed in percentage terms with respect to the investor's base currency.

Since the dollar began its fall from grace in 1985, it has been impossible, and not economically sound, to ignore the foreign currency bond markets. In the quest to enhance total return, many bond portfolio managers have not remained exclusively in the US dollar-denominated bond market. A very sound trading rule that can be used by portfolio managers as well as individual investors is to invest some percentage of

the portfolio in foreign currency bonds when the dollar is trending lower, and allocate 100% of the portfolio in US-denominated bonds when the dollar is higher.

A simple gauge can help determine the trend of the dollar: If the dollar's trade weighted value on a monthly average basis is above its one-year moving average, the trend is upward and vice versa. Therefore, investors would be taking advantage of both the US and foreign currency markets, but by definition because the signals are taken from moving averages, there would always be a time lag. In other words investors who utilize this rule can never expect to cross over into (or out of) foreign currency bonds exactly at the high (or low), because of the lag associated with averages, but to catch the trend would undoubtedly add extra basis points to the investor's portfolio.

Chart 24
Foreign Currency Bonds

DATE: October 22, 1987

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

ISSUER	BID	OFFER	CURRENT ANNUAL YIELD TO MTY.	LAST PAY DATE	NEXT PAY DATE	
NEW ZEALAND DOLLAR DENOMINATED BONDS						
COCA COLA	98 1/2	99 3/4	17.93	16/6/87-16/6/88		
16/6/89 18%						
HONDA INT'L	95	96 1/4	18.82	20/9/87-20/9/88		
20/9/89 16 3/8%						
HONDA INT'L	93 1/2	94 3/4	18.57	28/11/86-28/5/88		
28/5/90 16%						
TOURIST HOTEL CORP. (N.Z.)	39 7/8	41 1/8	17.20		matures 4/6/93	
4/6/93 zero coupon						
BANK OF NOVA SCOTIA	97 3/4	99	19.07	15/9/87-15/9/88		
15/9/89 18% RRSP eligible						
WELLS FARGO (semi-ann.)	95 3/8	96 5/8	19.61	12/5/87-12/11/87		
12/5/89 16 1/8%						
KODAK (semi-ann.)	97	98 1/4	19.36	15/8/87-15/2/88		
15/2/89 17%						
TORONTO DOMINION	97 1/4	98 1/2	18.62	2/4/87	2/4/88	
2/4/90 18% RRSP eligible						
AUSTRALIAN DOLLAR DENOMINATED BONDS						
CAN. IMP. BANK OF COMMERCE	96 3/4	98	13.70	13/3/87-13/3/88		
13/3/91 13% RRSP eligible						
BRITISH POUND DENOMINATED BONDS						
TORONTO DOMINION	94 1/4	95 1/4	10.58	20/5/87-20/5/88		
20/5/92 9% RRSP eligible						
DEUTSCHE MARK DENOMINATED BONDS						
GOVT. OF BELGIUM	89	89 3/4	7.14	29/4/87-29/4/88		
29/4/96 5 1/2%						
QUEBEC HYDRO	89 1/4	90	7.10	1/5/87	1/5/88	
1/5/96 5 1/2% RRSP eligible						
SWISS FRANC DENOMINATED BONDS						
GOVT. OF AUSTRALIA	97	97 3/4	5.27	30/10/86-30/10/87		
30/10/98 5%						
JAPANESE YEN DENOMINATED BONDS						
GOVT. OF CANADA	97 5/8	98 3/8	5.96	23/7/87-23/7/88		
23/7/93 5 5/8% RRSP eligible						
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	100.05-100.30		8 3/16%	7/1/88
		(quarterly)				

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

Chart 25

Eurobond Total Return Performance
Year-to-date returns in U.S.\$ terms

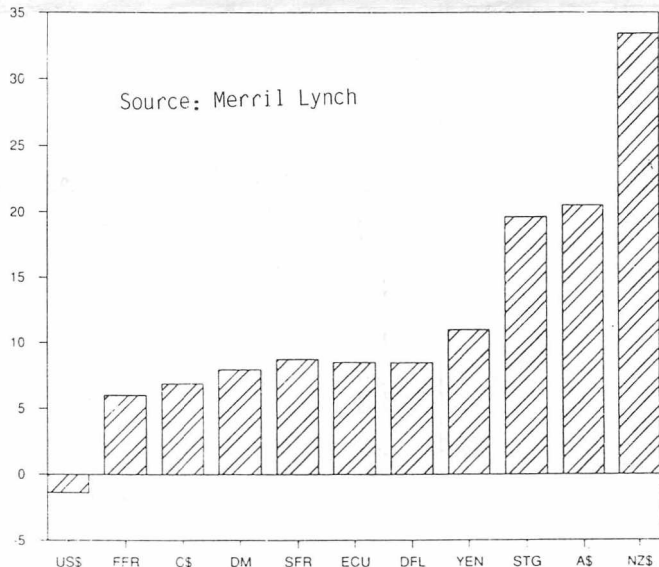


Chart 26
Breakeven exchange rates for US\$ — based investor

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 October 22, 1987.

	U.S. \$	NEW ZEALAND \$	AUSTRALIAN \$	DEUTSCHEMARK	SWISS FRANC	JAPANESE YEN	BRITISH POUND
2 year	7.77%	Bk. of Nova Scotia 18½% 15/9/89 yields 19.07% (.525 NZ/US)**					
3 year	8.11%		C.I.B.C. 13% 13/3/91 yields 13.7% (.628 AS/US)				
4 year	8.42%						Toronto Dominion 9¼% 20/5/92 yields 10.58% (1.78 BP/US)
6 year	8.61%	Tourist Hotel Corp. 0% 4/6/93 yields 17.20% (.406 NZ/US)				Canada 5% 23/7/93 yields 5.69% (124.8 US/JY)	
9 year	8.90%			Gvt. of Belgium 29/4/96 yields 7.14% (1.57 US/DM)			
11 year	8.96%				Australian 5% 30/10/98 yields 5.27% (1.03 US/SF)		
Spot Exchange Rate	N/A	.6425	.7139	1.8168	1.5065	144.83	1.6465

**For example, in parentheses, since a US\$ based investor would receive 1130 basis points (19.07% minus 7.77%) by holding the Bank of Nova Scotia bond, the NZ\$ can depreciate to .525 NZ/US from the spot exchange rate of .6425 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.

Forex Rates & Update

Currency	Spot	3-Month	12-Month	Comments vis à vis US\$	Comments vis à vis DM (Spot DM: 1.7850)
*Belgian franc	37.63-37.68	37.55-37.63	37.30-37.50	Buy	Liquidate
*Danish krone	6.9050-6.9100	6.9400-6.9500	7.0200-7.0600	Buy	Remain short
*Dutch guilder	2.0315-2.0325	2.0310-2.0320	1.9890-1.9920	Buy	Remain long
Greek drachma	139.10-139.20	142.10-144.40	151.10-161.10	Remain short	Remain short
Hong Kong dollar	7.8095-7.8105	7.7775-7.7800	7.7245-7.7555	Sell 12 months at 7.65 to US if available	
*Italian lira	1301-1304	1304-1306	1308-1310	Buy	Remain short
Kuwaiti dinar	.28120-.28140	.27980-.28045	.27520-.27705	Neutral	Remain short
Malaysian ringgit	2.5245-2.5255	2.5025-2.5065	2.4545-2.4750	Neutral	Neutral
New Zealand dollar	.6490-.6506	.6300-.6325	.5880-.5945	Remain long	Liquidate
Norwegian krone	6.6200-6.6250	6.7215-6.7315	6.9965-7.0110	Neutral	Neutral
Portugese escudo	142.20-142.60	143.70-145.60	147.20-152.60	Remain long	Neutral
Saudi Arabian riyal	3.7500-3.7505	3.7465-3.7490	3.7450-3.7505	Remain short	Remain short
Singapore dollar	2.0850-2.0860	2.0700-2.0725	2.0425-2.0485	Neutral	Neutral
*Swedish krona	6.3300-6.3350	6.3560-6.3650	6.4465-6.4600	Buy	Neutral
Venezuelan bolivar	32.45-32.60	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
Buy Sell
Sell Sell
Sell Buy

Cover

Liquidate

Hotline Update

Tuesday, September 22: The market letter is in the mail. No changes or new recommendations. There will be a special broadcast tomorrow, Wednesday, to replace the regular Friday update.

Flash update, 10:50 a.m., Wednesday: Sell December S&P at market, risking 327000, good anytime.

Wednesday, September 23: The market letter is in the mail. The following is a wrapup of the week's activities, as there will be no broadcast Friday night. Instead, there will be a recording Monday morning. This morning we recommended to sell S&P at market, risking 32700, good anytime, to replace the position that was covered yesterday at 32300, as per our previous stop recommendation. One new recommendation: cover short crude oil positions at 1960 stop, basis January, good anytime, replacing previous stops of 1960, basis January, *close only*.

Monday, September 28: No new recommendations. One note: We were stopped out of our short December S&P positions as per our stop recommendation on Friday of 32700.

Tuesday, September 28: Two changes: 1) Cancel recommendation to buy copper on 250-point dips from any high as suggested in our newsletter, and stand aside; 2) lower stops on short December T-bonds to 8405, *close only*.

Friday, October 2: Two changes instituted as of Tuesday: 1) Cancel recommendation to buy copper on 250-point dips from any high as suggested in our newsletter, and stand aside; 2) lower stops on short December T-bonds to 8405 *close only*.

Tuesday, October 6: No changes or new recommendations. There will be a tape tomorrow, Wednesday, October 7, after market hours, to replace our regular Friday recording.

Wednesday, October 7: One new recommendation: Buy December yen at the market, risk 6795, *close only*.

Monday, October 12: No new recommendations. One change: Lower stop on short December T-bond position to 8200, *close only*.

Wednesday, October 14: No new recommendation. One change: Raise stops on long December Japanese yen positions to 6975 stop, good anytime.

Monday, October 19: No changes or new recommendations.

Flash update, Tuesday, October 20, 1:40 p.m.: In our opinion the stock market decline is over, at least temporarily. Purchases can be made of December S&P 500 contracts at current levels but only for traders wishing to ride it without a stop. Purchases *should* be made of copper (down 900 points at this time), gold (down \$20 at this time), and CRB index (now trading at 223.75 basis December).

Our stop in Treasury bonds remains at 8200, basis December, *close only*. We now add a qualification: Do not pay above 83.16.

Flash update, Wednesday, October 21, 12:35 p.m.: You are long December S&P at around 212.00. Place stops at 241.00, basis December, good anytime.

On gold and CRB purchased yesterday, stops remain as suggested in the market letter, that is, 455.00, basis December, *close only*, and 219.00, basis stock index, *close only*, respectively.

Flash update, October 21, 1:15 p.m.: This is the second flash update of the day. Cover short T-bond positions at the market. This replaces the 82.00 stop, *close only*, limit 83.16, suggested yesterday. Now for the benefit of those who missed it, I will repeat verbatim the first flash of the day. You are long December S&P at around 212.00. Place stops at 241.00, basis December. On gold and CRB purchased yesterday, stops remain as suggested in the market letter, that is, 455.00, basis December, *close only*, and 219.00, basis stock index, *close only*, respectively.

Flash update, Friday, October 23, 9:15 p.m.: Buy December DM, SF, & JY at market, placing stops at 5500, 6640, 6932 respectively, good anytime.

Friday, October 23: A recap of our open positions, including all flash updates:

1. Long December copper as per October 20. Place stops at 7600, *close only*.
2. Long December gold with stops at 455.00, *close only*.
3. Long December CRB with stops at 219.00, basis the index, *close only*.
4. Long December DM, SF, JY as of today with stops of 5500, 6640, and 6932 respectively, good anytime.
5. Long December silver with stops at 710, *close only*.

Note: We covered our short December T-bond position on Wednesday, October 21 at approximately 8319.

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