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The real danger

It's not that we're heading into a recession; rather, it's that we prolong the boom conditions until a deep depression becomes inevitable.

The facts are that before the Oct. 19 crash, the US economy had been coasting along at near-boom conditions (see *FC&CC* Sept. 20, 1987) as evidenced among other things by the low unemployment numbers, the jump in non-farm payrolls, the sharp 33% increase in corporate profits for the third quarter (from a *Wall Street Journal* survey), a further pick up in industrial price inflation, a lengthy list of items in short supply (both from the purchasing agents survey for October), and so on. Moreover, *there is no clear-cut evidence that a stock market debacle causes a business contraction*, although it would appear that, as with any sudden, highly publicized and negative shock, it could dampen *temporarily* economic activity. What *is* clear is that US monetary authorities are likely to err the side of ease so as to avoid a recession, as remote a possibility as it may be.

In general, expected monetary effects are neutral with respect to real economic activity. Thus, as an example, expected inflation does not lead to accelerated economic growth. Unexpected inflation, on the other hand, does lead to a temporary spurt in activity, which is negated once the mindset of our economic participants is able to adjust to the new conditions. As a consequence of the huge build-up of money and credit experienced over the past five years and the relentless depreciation of the US dollar over the past two and a half years, we appear to be in the midst of a bout of unexpected inflation (which, incidentally, manifests itself in a rising spread; see "Supply-side spreads signal boom.").

Rational expectation theorists deny the existence of this mechanism. They argue that economic participants are rational and that in possession of sufficient data, they would be able to distinguish between genuine increases in demand and mere inflation. As a result, rational entrepreneurs, fully cognizant of the temporary nature of the demand and the unusually wide profit margin do not increase investments; rational workers adjust upwards their wage demand, *anticipating* inflation.

Real life, however, is not *that* rational. Market participants are more likely to project the recent past rather than recreate entirely new scenarios. Rarely, if ever, do we witness economists projecting sharp inflection points; almost always, the future follows the past on a smooth trendline (it is thus that implied volatilities in options — to cite just one market observation — rise violently only *after* the most recent historical volatilities explode; conversely, low implied volatility follows periods of extraordinary quiet). The human mind does not seem capable of escaping inertial thinking — at least in economic matters.

It is thus that the transition to accelerated inflation is not foreseen nor is it initially accepted even while it is happening. Low inflation periods beget low inflationary expectations; high inflation periods beget high inflationary expectations; rising or accelerating inflation begets hyperinflationary expectations.

If low inflation begets low inflationary expectations, what shatters the calm? Why does it not become a desirable never-ending process? One reason may be the minority of truly rational participants. Seeing the conditions for an inflection in the near future, they begin to act upon the market.

It is thus that markets "discount," or "anticipate," events that to the majority of observers do not seem obvious. Sensitive markets, such as foreign exchange and gold begin to evidence the telltale signs of change — while the unsuspecting majority continues to argue the case for no change.

A second, and very powerful, reason is the appearance of shortages and their impact on prices. As participants come to expect low and/or lower future inflation, inventories are allowed to run down to extremely low levels, in the hope of avoiding capital losses and excess financing costs. The inventory cycle (to which we alluded in earlier issues; see *FC&CC*,

In this issue

Contrary to popular belief, the economy is headed into an inflationary boom — and that means a boom in the price of gold, so we stay long. The stock market will rally to much higher levels before continuing its slide . . . so we stay long that, too. Also, a look at the US budget labyrinth, interest rate futures, and Friedberg Capital Markets. Contributions by Albert D. Friedberg, Steve H. Hanke, Michael D. Hart, and Daniel A. Gordon.

May 24, 1987) magnifies price declines and subsequent price increases. Low inventories become insufficient to meet steady but undramatic demand, and shortages begin to occur.

Shortages imply rising prices — sharply rising prices. At first, in only one isolated case; later, in a number of commodities. Psychology begins to change: inflationary expectations are awakened — the dream is shattered.

One need not go very far to identify the current situation with the onset of this inflationary expectations phenomenon. First there was copper and aluminum, then nickel, cadmium and bismuth; now, no fewer than five other actively traded commodities are in backwardation (that is, where tight cash supplies trade at a premium to deferred deliveries): soybean meal, frozen orange juice, live cattle, live hogs, and lumber. As multi-year highs in a number of commodities are achieved, inflationary expectations are reawakened.

The CRB futures price index ("CRB index") has managed to remain above the early summer support of 220 despite the inclusion of a number of fundamentally "weak" commodities (such as crude oil, oil products, and a large sample of grains) and fears of a recession following the October stock market crash (see Chart 1). Our breadth analysis (see Chart 1) indicates that a powerful upside breakout is in the offing. In fact, a move above 236 would penetrate the 1981/1984/1987 downtrend (see Chart 2) and initiate a NEW INFLATIONARY ERA.

What then is our economic scenario for the next 12 to 18 months? The economy probably will reaccelerate (see Steve Hanke's report "Supply-side spreads signal boom"), raw material prices will skyrocket, labor costs will follow, and the Fed will put the brakes on — as usual, too late.

The real problem will occur *then*, as an overheated and highly inflated economy clashes with tight money.

As an entertainer from an earlier depression said, "You ain't seen nothin yet."

Chart 1

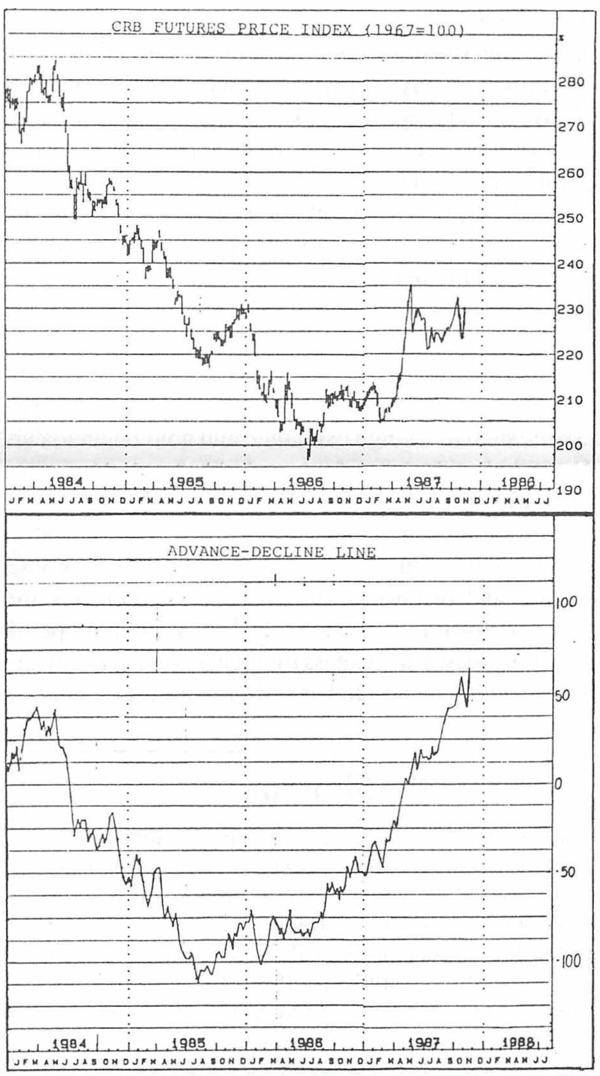


Chart 2

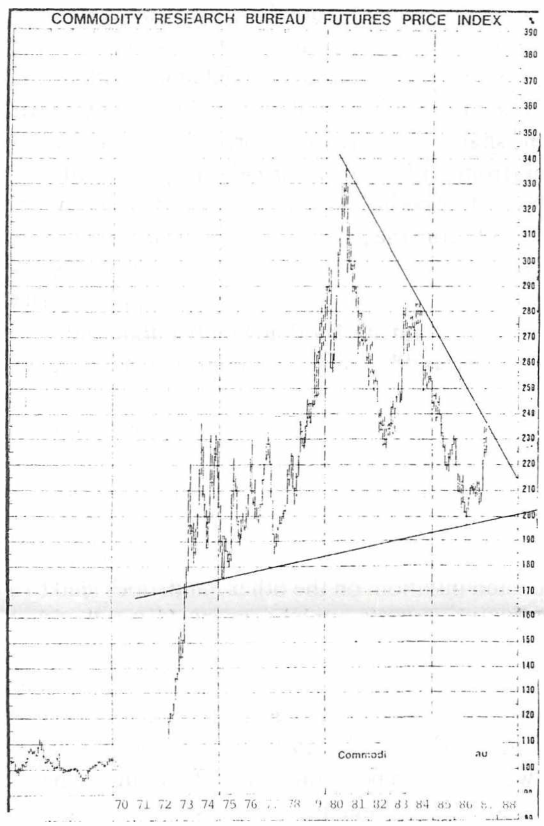
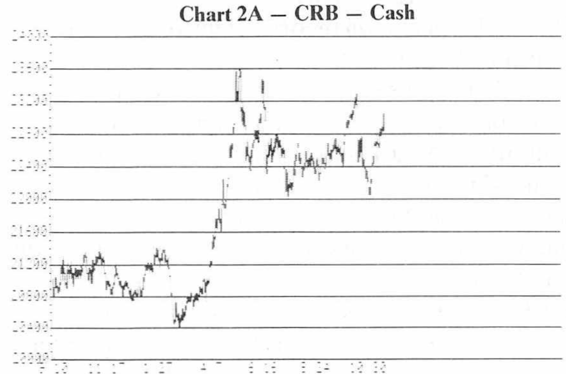


Chart 2A — CRB — Cash



Supply-side spreads signal boom

Commodity traders are familiar with the simple analytics of spreads between the value of outputs from certain manufacturing processes and the cost of a significant input into those processes. For example, in the soybean complex there is the so-called "crush spread." The crush spread equals the difference between the value of outputs from processing soybeans (soybean oil plus meal) and the cost of the soybean input. In the energy complex, there is the so-called "crack spread." It equals the difference between the value of outputs from refining crude oil (gasoline plus heating oil) and the cost of the crude input.

The economics of these spreads are rather straightforward. Positive spreads (particularly when they are widening) generate production booms because production (for example, soybean processing and crude oil refining) is profitable. With booms, production capacity becomes more fully utilized; the demand for inputs increases; and the price of inputs rises. Production busts (reduced capacity utilization, input demand, and input prices) are, of course, associated with negative spreads (particularly when they are widening), because production is unprofitable.

* * * * *

We can extend the simple analytics of spreads from a single production process to the economy as a whole. To this end, we build on some insights made by Professors Lowell Gallaway and Richard K. Vedder in an article ("Wages, Prices, and Employment: Von Mises and the Progressives") that appeared in the *Review of Austrian Economics*.

Our economy-wide spread model is a pure supply-side model. To construct it, we must identify the economy's most significant input. This isn't too difficult. Labor is clearly the most important single input. For example, about 60% of total manufacturing costs are labor costs. Given the importance of labor in the economy, we propose an economy-wide spread that is measured by the difference between the value of outputs produced by a unit of labor and the cost of outputs produced by a unit of labor.

On the output side (the value side) of the spread, we don't have a direct measure for the value of outputs produced by a unit of labor; hence, we construct a proxy for the trend in this measure. It is equal to the change in prices (measured by the change in the consumer price index) plus the change in productivity (measured by the change in output per worker hour). On the input side (the cost side) of the spread, we have a direct measure for the trend in the cost of output produced by a unit of labor: It is the change in unit labor costs. Based on these measures, we can compute economy-wide spreads for the United States (see Chart 3).

The economy-wide spread model works in the following manner: When the spread is positive, it should signal that profits are rising, firms are increasing capacity utilization, businesses are hiring more labor, and the economy is expanding. When the spread is negative, it should signal the opposite: falling profits, falling capacity utilization, falling labor demand, and a contracting economy.

Chart 3 shows that the economy-wide spread model works as it should. Since 1973, it has signalled future economic growth and contraction with a high degree of reliability, forecasting expansions and recessions with nearly equal precision. For example, in 1974, the spread turned negative, signalling falling profits, reduced capacity utilization, layoffs, and recession. The model was on target. When the spread turned positive in 1975, it flashed a recovery signal. Again the model was on the mark. A review of the data in Chart 3 shows that the economy-wide spread has correctly anticipated the economic booms and busts since 1973.

* * * * *

Now, the question is: Given the current spreads, what course can we anticipate for the economy? Contrary to the legion of soothsayers who argue that a recession is just around the corner, the economy-wide spreads (measured for the entire economy or for the manufacturing sector alone) suggest that the expansion should become stronger and that a boom is just around the corner. This means that capacity utilization, which is running at an 81.3% rate for the entire economy and an 81.7% rate for the manufacturing sector (a seven-year high), should increase. It also means that the demand for labor should increase. This injection of new labor demand will be made into a market that is starting to show signs of tightness: The Help-Wanted Index currently is 154, which is close to its all-time high of 158, and the employment ratio (the percent of the population over 16 years of age that is employed) is 61.7%, which is as close as you can come to the all-time high of 61.8%.

Our supply-side, boom forecast holds the vital key to our views about the future course of inflation. During the past year, industrial commodity prices have, in large part, soared, because consumers have attempted to rebuild their inventories. For example, *The Economist's* Commodity Price Index for industrial commodities has increased by 41% (in US dollars) over the past year. Even though these price increases have been large, they have not played too great a role in the overall inflation picture, because commodity inputs make up only about 9% of the total cost of manufacturing. If this weren't enough, overall inflation has been kept "under control" because increases in labor costs have been modest. For example, during the first three quarters of 1987, unit labor costs have increased at an annualized rate of only 1.3%, and for manufacturing, unit labor costs have actually fallen at an annualized rate of 3.8%. Given that labor costs make up 60% of the total costs of manufacturing, we shouldn't be too surprised to observe that cost-push inflation has been all but absent from the economic scene.

The supply-side spread model suggests that all this is about to change. With the large economy-wide spreads of 5.1% and 13.3% (see Chart 3) for "the economy" and "only manufacturing," respectively, capacity utilization and the demand for labor will increase. As the labor market tightens, wages will be pushed upward, and unit labor cost soon will begin to increase. In consequence, unit labor costs, which have been acting as a retardant on the sparks of inflation, will suddenly begin to act as a cost-push inflationary fuel.

In the coming months, we therefore anticipate boom conditions and a sharp up-tick in unit labor costs. With this, the cost-push side of inflation will raise its head.

STRATEGY: *Favorable implications for all positions that are motivated by inflationary boom conditions. See Interest Rate Futures, Gold, Copper.*

— by Steve H. Hanke

Chart 3
Supply-Side, Economy-Wide Spreads
(Rates of change)

	Prices Plus Productivity	Unit Labor Costs	Spread
1973	8.8%	5.3%	+ 3.5%
1974	8.6%	12.1%	- 3.5%
Recession followed by recovery			
1975	11.3%	7.3%	+ 4.0%
1976	9.1%	5.1%	+ 4.0%
1977	7.9%	5.1%	+ 2.8%
1978	8.3%	8.0%	+ 0.3%
1979	9.7%	11.2%	- 1.5%
Recession followed by early recovery			
1980	12.8%	11.0%	+ 1.8%
1981	11.4%	8.3%	+ 3.1%
1981 II-III	10.1%	10.0%	+ 0.1%
Recession followed by delayed recovery			
1982	5.5%	8.4%	- 2.9%
1982 III-IV	7.0%	3.3%	+ 3.7%
1983	6.5%	1.1%	+ 5.4%
1984	6.1%	2.1%	+ 4.0%
1985	4.1%	3.5%	+ 0.6%
1986	3.5%	2.2%	+ 1.3%
1987 I-III	6.4%	1.3%	+ 5.1%
1987 Mfg. Only I-III	9.5%	-3.8%	+13.3%

Sources: U.S. Bureau of Labor Statistics: Warren Brookes.

Note: National Bureau of Economic Research tabulations indicate that recessions began in each period directly above the rows labeled "Recessions followed by…recovery." Recoveries began in the first period under the rows labeled "Recession followed by…recovery" in which a positive spread occurred.

Gold

Up, up and away…

In our opening comments we alluded to two highly sensitive markets that evidenced very early inflection points in the rate of inflation: foreign exchange and gold. While the former have followed the usual script, gold has not been "acting" well.

The bears, of course, need no explanation: Huge supply increases, they say, are overwhelming the market (for a rebuttal of this point, see the following article), inflation is dead, and so on. Their arguments would be plausible but for the fact that *on a day to day basis, gold is weakest when the dollar is weak*, an illogical and totally unnatural reaction.

Let us air our suspicion: *Gold is made to look weak.* But by whom? And why? Now our theory: In early October, Treasury Secretary Baker suggested that major industrial nations base their economic policy planning in part on the relationship among the various currencies and a basket of commodities including gold. This attempt to (appear to?) return to a long lost and more traditional form of central banking was unexpected. While the Louvre Accord moved towards satisfying German and Japanese demand for dollar stabilization, no one had talked about commodity prices — least of all gold. In fact, the surprise reaction of other central banks, arguing that an index was not needed and that, at any rate, gold should represent only 5% or less of any new index as against 20% favored by Treasury Secretary Baker, betrayed a sense of unilateral expediency rather than an intellectually-based cooperative evolution.

Why this sudden interest in commodity prices and especially gold? It may very well be the brainchild of Alan Greenspan who had already indicated in previous Congressional testimony *that he feared most the return of inflationary expectations.*

Would a skyrocketing price for gold (well past $500/oz.) signal a change in expectations? We must definitely believe so. Would a dormant range for gold of $450 to $480/oz. mean that inflation was not consequential? Most probably. Couldn't the Fed/Treasury team influence expectations if they could first divert the market's attention to commodities (and more particularly, gold) and then sell gold at any time that the price threatened to "break out" on the upside, thus holding down the price?

Interestingly enough, rumors have circulated for weeks that central banks have been important sellers of gold on the London bullion market. As of 14 days ago, sales equal to 100 tons were mentioned (equal to $1.4 billion — not a pittance). Secret central bank sales are not new: For a long time during the '60s, the Bank of England managed on behalf of the US and other major nations the sale of gold on the London bullion market in order to maintain the old $35/oz. parity. In 1968, as gold losses mounted, the Gold Pool (as it was then called) was dissolved. While the early operations of the gold pool were secret, with time the secret was revealed. It was then that speculators gobbled up with gusto almost $3 billion of cheap bullion. Less than three years later (and it would have been much earlier were it not for the tight-money-period-cum-recession that took place in 1969-1970) gold was floating well above the upper intervention point.

If indeed central bank sales have taken (are taking?) place — which is quite likely given the unusual behavior of prices during days that are expected to show strength — one could only surmise that a) it will not be long before the rumor is confirmed, b) at which point the strategy of demonstrating that inflation is not consequential will backfire, c) causing enormous gold losses to the sellers (knowing of the European's love for gold, the bulk of the bullion for sale must belong to the US). If the dollar support in the foreign exchange market last May, which equalled $40 to $60 billion is any indication, Fort Knox could empty in a few weeks ($123 billion worth of gold at $470/oz.).

STRATEGY: *Our* minimum *upside target, within the next two years is $850/oz. Remain firmly long; there is, at this time, no downside risk whatever.*

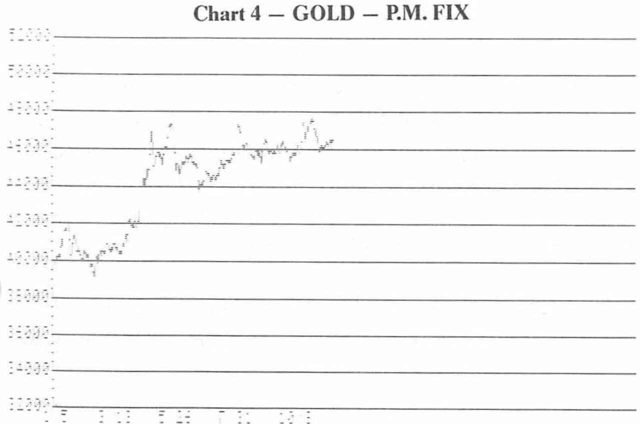
What gold glut?

Over the past year, the financial press, which has been led by *The Economist* of London, has fed us a steady diet of stories about an impending gold glut. The journalists have developed their thesis by focusing exclusively on the supply-side of the gold market. While we have no quarrel with the fact that new discoveries and new, low-cost extraction practices will increase the supply of gold, we do have a major bone to pick with the simple-minded conclusion that gold prices must, therefore, plummet.

To determine the future course of a commodity's price, we must analyze both supply and demand. Chart 5 contains worldwide data about supply-demand balances for gold, as well as conservative forecasts made by Drexel Burnham Lambert. Contrary to the inferences that are drawn from the reportage in the financial press, the so-called "market surplus" is projected to fall slightly to 16.3 million ounces in 1987 from 16.5 million in 1986. Moreover, the projected market surplus for 1987 is below the figure for 1980 (20.6 million ounces) and for 1983 (19.4 million ounces), which were years of explosive and relatively strong gold prices, respectively.

Let's now go beyond the data in Chart 5 and comment on the economics of the demand for gold. There are two incentives to hold gold: the so-called "use-value" incentive and the so-called "asset-composition," or "portfolio-mix," incentive. Gold's use-value incentive derives from the implicit rate of return accruing to owners from the use of highly durable objects that contain gold (for example, jewelry, art objects, and various industrial durable goods). The demand for gold that is motivated by the use-value incentive is contained in Chart 5 under the heading "Fabricated Demand." If anything, the forecasts in this category might be a bit on the low side because the price of gold in the stronger currencies has fallen during the past year. This implies a higher net use-value return on new purchases of durable objects that contain gold, particularly in countries like Japan and Germany. This factor hasn't been fully accounted for in the forecasts.

Chart 4 — GOLD — P.M. FIX



Gold's portfolio-mix incentive derives from the attractiveness of including gold in a portfolio of assets in light of the prospective changes in the real value of gold. This may provide a positive incentive under a considerable range of expected rates of real capital gain, which often even include capital losses. To understand this last point, recall a basic lesson from modern portfolio theory: Even with an expected moderate real capital loss, gold may have a legitimate place in a portfolio, if other assets expected to yield a positive real return carry larger risks of major loss (for example, either a larger market risk or a larger political risk). But, other things being equal, the portfolio-mix incentive will be more powerful the higher the expected rate of capital gain on gold.

The portfolio-mix incentive is tied up in the "Investment Demand" category in Chart 5. As you can see, the forecasts in this category are largely blank. Given the recent action in the international equity markets, the international debt situation, the increasing tensions in the Middle East, and our views about inflation (see "Supply-side spreads signal boom" in this issue) — we conclude that the portfolio-mix incentive for demand will become stronger. Hence, the blanks in Chart 5's "Investment Demand" category should contain strong numbers.

A gold glut is not in the supply-demand numbers. Indeed, the market can be considered to be rather tightly balanced. As the portfolio-mix/demand incentive strengthens, gold prices will surge upward.

— by Steve H. Hanke

Chart 5
Worldwide Gold Supply-Demand Balances
(Million Ounces)

	1970-79 Average	1980	1981	1982	1983	1984	1985	Forecast---- 1986p	1987f
Fabricated Demand									
Jewelry-Dev	16.7	10.4	13.3	14.9	13.8	15.7	17.3	16.9	17.0
-Undev	11.5	6.4	11.7	13.6	12.6	17.4	18.2	16.7	17.0
Subtotal	28.2	16.8	25.0	28.5	26.4	32.1	35.5	33.6	34.0
Industrial									
Electrical	3.0	3.0	3.0	2.9	3.3	4.0	3.6	3.6	3.7
Dental	2.3	2.0	2.1	2.0	1.7	1.7	1.8	1.8	1.8
Other	1.9	1.8	1.7	1.6	1.6	1.5	1.5	1.5	1.5
Subtotal	7.3	6.8	6.8	6.5	6.6	7.2	6.9	6.9	7.0
TOTAL DEMAND	35.5	23.6	31.8	35.0	33.0	40.3	42.4	40.5	41.0
Primary Supply									
South Africa	25.9	21.7	21.1	21.4	21.8	22.0	21.6	20.6	19.9
Canada	1.9	1.6	1.4	2.1	2.4	2.7	2.8	3.4	3.6
United States	1.2	1.0	1.4	1.4	2.0	2.1	2.5	3.7	3.9
Others	5.3	6.0	6.4	6.6	7.6	8.4	9.5	10.1	11.4
Subtotal	34.2	30.3	30.3	31.5	33.8	35.2	36.4	37.2	38.8
CPE Net Sales	7.5	2.9	9.0	6.5	3.0	6.6	6.8	13.0	11.0
Secondary Supply	4.0	18.4	9.0	9.4	11.0	10.2	9.4	12.6	11.5
Official Sales	3.1	-7.4	-8.9	-2.7	4.6	2.7	-4.3	-3.8	-4.0
Subtotal	14.6	13.9	9.1	13.2	18.6	19.5	11.9	19.8	18.5
TOTAL SUPPLY	48.8	44.2	39.4	44.7	52.4	54.7	48.3	57.0	57.3
BALANCE	13.3	20.6	7.6	9.7	19.4	14.4	5.9	16.5	16.3
Investment Demand									
Idntfd Bullion	2.4	0.7	8.7	9.5	2.5	10.7	9.9	7.1	--
Official Coins	5.3	7.7	7.3	5.3	3.7	4.0	3.5	10.2	5.0
Medallions	1.2	1.2	0.9	1.2	1.1	1.0	0.4	0.3	0.3
Subtotal	8.9	9.6	16.9	16.0	9.3	15.7	13.8	17.6	--
(Unidentfied)	4.4	11.0	-9.3	-6.3	10.1	-1.3	-7.9	-1.1	
GOLD PRICES	$133	$612	$459	$376	$424	$360	$318	$368	
Addendum:									
USSR Prod	8.4	9.3	9.6	9.5	9.1	8.7	8.7	8.8	8.8
Other CPE	1.7	1.9	1.9	2.0	2.1	2.5	2.3	2.6	2.9
Subtotal	10.1	11.2	11.5	11.2	11.2	11.2	11.0	11.4	11.7

Sources: Consolidated Goldfields, Gold 1986, J.Aron/Goldman Sachs, The Gold Institute, USBM, WBMS, DBL Estimates

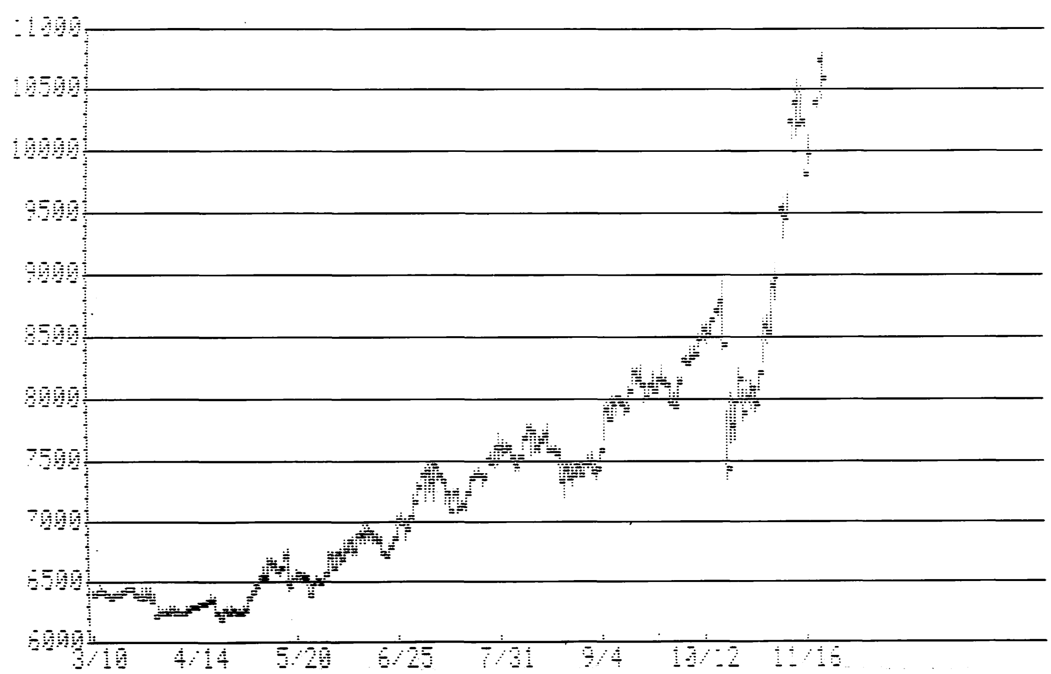
Copper

We said last month "...in our opinion, the Fed is likely to overreact, and copper will rise to new recovery highs in very short order." It has, reaching a multi-year high at $1.09, basis spot, December '87.

In the short period of one month (since we last recommended to buy December '87 copper), the red metal has advanced a spectacular 36 cents, moving to a 13 cent backwardation (December '87 over March '88). Under normal circumstances, the magnitude of this backwardation should attract physical lenders to the market and relieve the extreme tightness. But these are not normal times: Inventories have been drawn down to bare levels, and the economy gives no signs of contracting. Relief may be painfully slow at coming. Producers and exporters would be well advised to step up production; spiking prices deter consumers and, in the long run, induce substitutions.

STRATEGY: *Roll December '87 positions over to March '88; raise stops on March '88 to 88.00, close only.*

Chart 6 — COMEX COPPER DEC 87



Stock Indexes

It is true that bear markets do not end in one day. But it is also equally true that they do not go straight down. On a positive note, volume has dried up on down days, the list of new lows has contracted sharply as have the Treasury/Junk yield spread and the Ted spread, both indicative of fear. The market has absorbed rather well the lack of decisive Congressional action on the budget. Still, some technical problems remain. Big cap stocks still are performing better than secondaries: breadth has been abysmal; we have not detected *any* new highs.

On a more fundamental basis, US stocks appear reasonably priced in terms of "hard currencies," especially at a time when US manufacturing has gained an important competitive edge. Still, price-earnings ratios are nothing to write home about (15-15.5), and bond yields continue to offer superior returns.

An overlooked technical plus is the fact that the 1982-1985-1987 long-term uptrend remains intact, despite the massive sell-off (see Chart 8). The market is *too oversold* to effectively gather enough downside momentum, at this time, to pierce this uptrend. Much more likely, it will first rally into the Dow Jones Industrial Average 2200 to 2400 range (280-300 on the S&P 500) before deciding to make fresh lows.

STRATEGY: *Remain long as per recent Hotline Update; place stops at just below 220, basis cash S&P 500 index, close only.*

Chart 7 — CME S&P 500 INDEX NOV 87

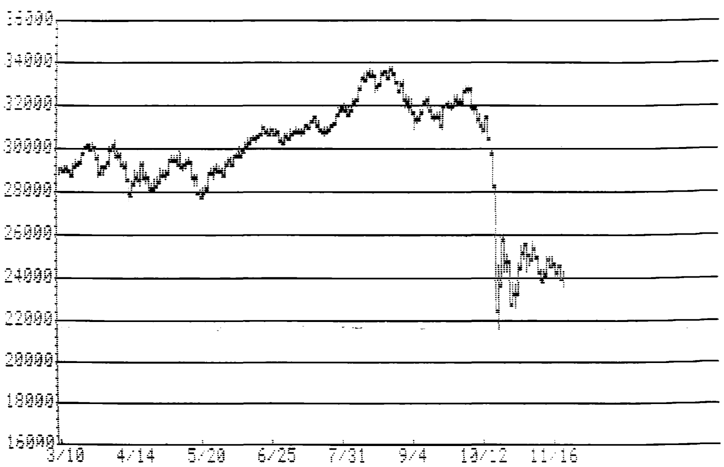
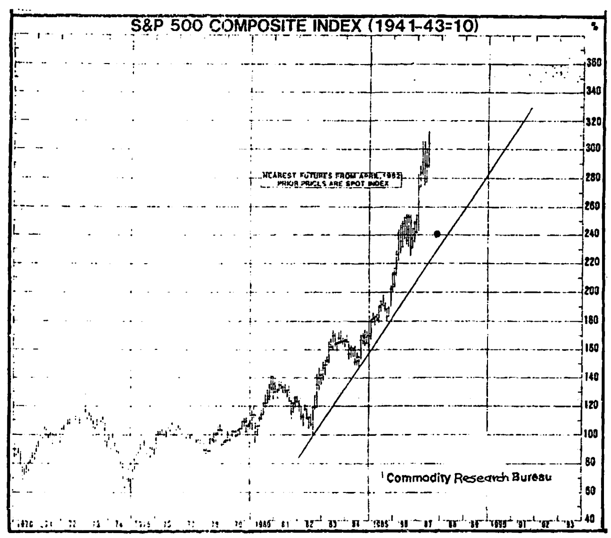


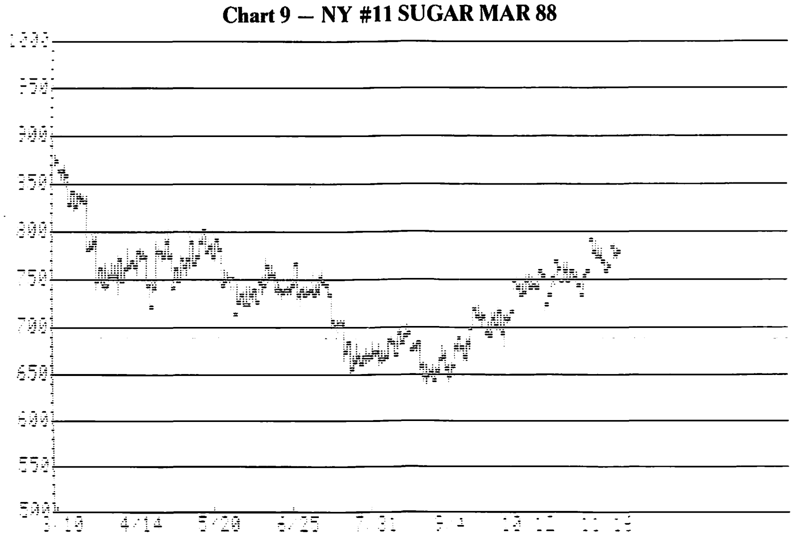
Chart 8



Sugar

STRATEGY: *Raise stops on long positions to 7.24, basis March '88, close only.*

Chart 9 — NY #11 SUGAR MAR 88



The budget labyrinth

Last week, the White House and Congressional negotiators reached a so-called "summit accord" about reducing the US federal budget deficit. President Reagan signed this accord and later signed an order to activate automatic spending cuts under the Gramm-Rudman-Hollings (G-R-H) law. Confusing? Of course it's confusing. It is the product of those self-important residents of Washington, D.C. whom we euphemistically refer to as our national leaders.

Since the status of the federal budget negotiations will become even more confusing in the coming weeks, we offer a highly simplified guide to the budget labyrinth. We hope this will allow you to avoid being whipsawed by forthcoming press releases from Washington, D.C.

The one given in the budget labyrinth is the G-R-H law.

Since G-R-H is a *law*, it has teeth. It requires that government spending for fiscal year 1988 be reduced (sequestered) from planned levels by $23 billion. The G-R-H would also reduce fiscal 1980 spending by $30 billion.

The summit accord does not have teeth. It is not a law. In fact, at present, it is nothing more than a bipartisan "handshake" between Congress and the White House in which the parties to the shake have said: "We (Congress) will produce legislation that will reduce the planned budget deficit by $30 billion ($21 billion in spending cuts and $9 billion in tax increases) in fiscal 1988 and $45 billion in fiscal 1989, and I (the President) will sign such legislation." Now, if such a budget reconciliation package (one that follows the terms of the summit accord) cannot be sent to the President by Dec. 16, 1987, the G-R-H law will hold, and the summit accord will have amounted to nothing more than a handshake.

It could be Dec. 16 until we know whether the summit accord will produce a change in the law, and therefore, whether it will displace G-R-H. Here's how we see the schedule for the coming weeks:

• **Nov. 23** — Since all politicians will be planning their Thanksgiving holiday, nothing will occur.

• **Nov. 30** — This will be the first week of action. It will occur in the Senate because the House has already passed its version of a budget reconciliation bill. The summit accord will take specific form as leading senators offer amendments to a budget reconciliation bill. At this point, watch for any violations of the summit accord. If they occur, the White House could object and the process could come unglued.

• **Dec. 7** — Assuming that the Senate passes a budget reconciliation bill, it will most likely be sent, along with the House budget reconciliation bill, to a conference committee of the Senate and House during this week. So, while President Reagan is playing host to Secretary General Gorbachev, the conference committee will be meeting behind closed doors, attempting to hammer out a budget reconciliation bill that can be voted on and sent to the President. During the conference committee deliberations, the risks of a breakdown in the summit accord will be at their highest. There is a risk that the taxes proposed will exceed $9 billion. There also is a risk that key conferees will not be able to agree on the composition of taxes, even if the level is $9 billion. On this issue, the most interesting conflict that has begun to arise is the one between the Speaker of the House, Jim Wright, and the Chairman of the House Ways and Means Committee, Dan Rostenkowski. Mr. Wright would like to use the full $9 billion of new taxes to increase welfare spending. This would please his "constituents" in the House. On the other hand, Mr. Rostenkowski would like to "use" a good part of the $9 billion for certain tax breaks for his friends.

• **Dec. 14** — If the deliberations in the conference committee are successful, a conference report will go to the Congress for debate. If it makes it that far, there might be some stalling, but there probably will be action by the Dec. 16 deadline.

For a clearer picture of the budget deficit issue, you will have to stay tuned. Little was really resolved by the summit accord. The *real* action will take place between Nov. 30 and Dec. 11.

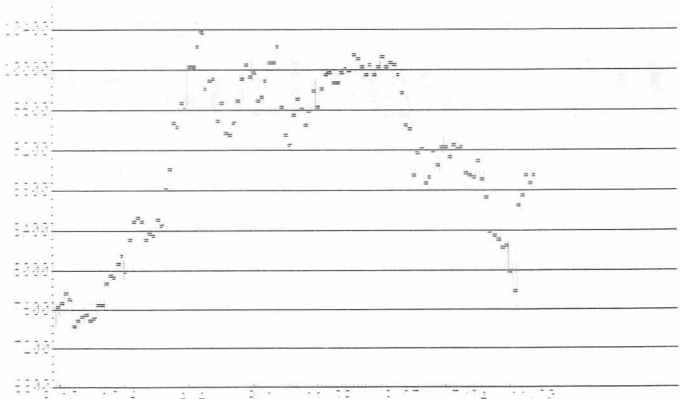
— by Steve H. Hanke

Interest Rate Futures

Our scenario calls for a strong pick-up in economic activity and inflation in the coming months (see "Supply-side spreads signal boom" and "The real danger"). We therefore believe that interest rates are about to resume their upward course after their crash-inspired, fear-inspired correction. More precisely, we believe that long rates will rise despite any easing attempts by the Fed, thus steepening even further the positive yield curve.

STRATEGY: *We sold March '88 T-bonds (as per Nov. 12 Hotline Update) at present levels. Place stops at 89.27, close only.*

Chart 10 — T-BONDS (DAY) DEC 87



Currencies

US dollar

The US dollar's fairly predictable downward path has provided us with a number of very profitable trading opportunities (see full record in our Hotline Update review). In our last foray we bought December '87 yen, December '87 DM, and December '87 SF at around 69.86, 55.62, and 67.20, respectively, on Oct. 23 and exited at around 74.10, 59.80 and 73.00 on Nov. 20 for profits of between $5,000 and $7,200 per contract.

A trading range may develop between DM1.65 and DM1.70. The trade deficit is unlikely to improve (despite flimsy appearances to the contrary) unless and until the US experiences tight money and a full blown recession (see previous issues on reasons for the growing current account deficit).

STRATEGY: *Move to sidelines. Keep in touch, however, via the Hotline for further trading opportunities.*

Australian dollar

STRATEGY: *Once again, the Aussie dollar can be bought at these levels for a move into the 72 to 73 area. Buy March '88 contract and place stops at a close below 67 cents, basis spot.*

Chart 11 — CME JAPANESE YEN DEC 87

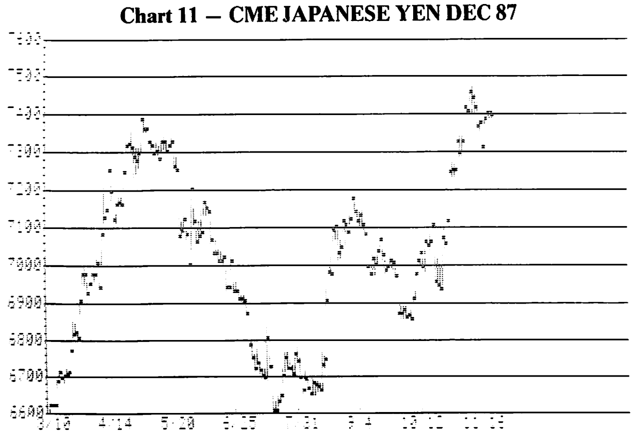


Chart 12 — CME SWISS FRANCS DEC 87

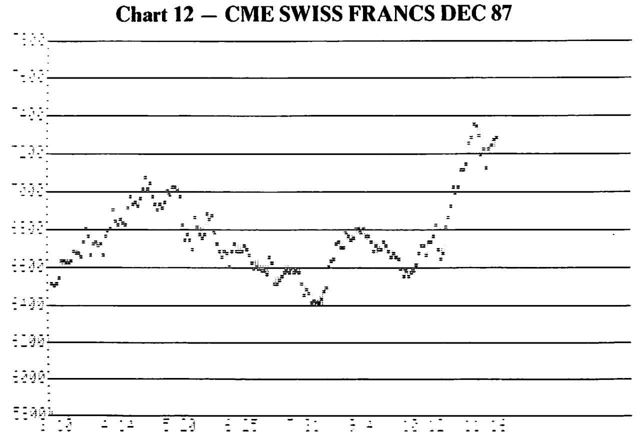


Chart 13 — CME DEUTSCHE MARK DEC 87

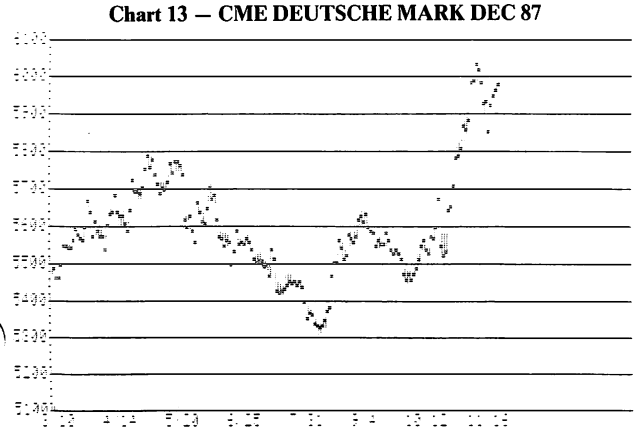
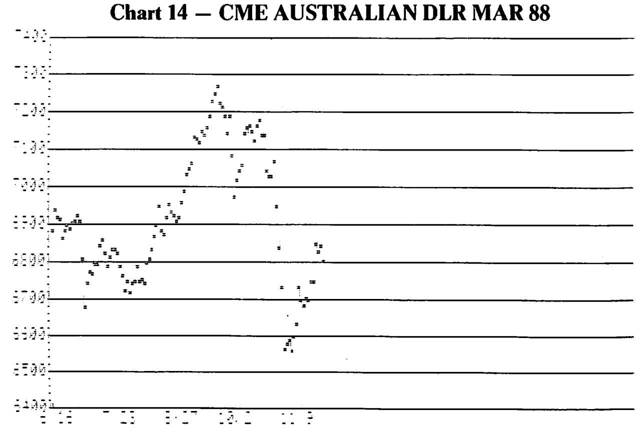


Chart 14 — CME AUSTRALIAN DLR MAR 88



The Exotics

Norwegian krone

Restrictive monetary and fiscal policies have cooled off the credit-backed private consumption boom, which had grown by an unsustainable 17% between 1984 and 1986. Recent retail sales statistics show a fairly steep year-by-year decline exceeding 6%.

Norway's minority Labor government has presented the 1988 draft budget to parliament, which increases state spending by a nominal 6.6% and which foresees a deficit of an Nkr 393 million (before loan transactions) compared with a projected surplus of Nkr 2.5 billion this year. The nearly balanced budget, however, is a product of raising taxes on various products and lifting subsidies. In view of the large current account deficit experienced this year, Nkr 32.5 billion, or 7.9% of GNP, the government has pledged continued tight policies.

Inflationary cost pressures remain high with year-over-year increases in manufacturing hourly earnings of more than 18% and consumer price increases hovering close to 10% per annum.

Norway has allowed the Nkr to depreciate vis à vis the DM by up to 5.5% since last September and is likely to continue this slight pattern of depreciations to maintain international competitiveness. Forward discount remains too steep to be able to take advantage of the continuing depreciation.

STRATEGY: *Stand aside vis à vis the DM and trade against the US dollar, when and if dollar sales are suggested, against the main currencies.*

Chart 15

				BASKET: U.S. 9%, U.K. 35%, Netherland 7%, Sweden 21%, Germany 27%, Denmark 9%	
YEAR	NORWEGIAN KRONER PER U.S. DOLLAR (PERIOD AVG)	U.S. 1970=1.00	U.S. 1979 =1.00	1970 =1.00	1979 =1.00
1967	7.1504	1.0140	1.5455	1.0984	1.1663
1968	7.1430	1.0191	1.5534	1.0121	1.0766
1969	7.1444	1.0430	1.5898	1.0313	1.0970
1970	7.1471	1.0000	1.5242	1.0000	1.0637
1971	7.0436	0.9657	1.4720	1.0194	1.0843
1972	6.5882	0.8586	1.3087	0.9800	1.0423
1973	5.7658	0.7531	1.1479	0.8929	0.9498
1974	5.5397	0.7340	1.1187	0.8682	0.9235
1975	5.2269	0.6773	1.0323	0.8494	0.9035
1976	5.4565	0.6850	1.0440	0.8000	0.8510
1977	5.3235	0.6521	0.9940	0.7957	0.8464
1978	5.2423	0.6395	0.9748	0.8490	0.9030
1979	5.0641	0.6561	1.0000	0.9401	1.0000
1980	4.9392	0.6553	0.9988	1.0036	1.0675
1981	5.7395	0.7391	1.1265	0.9929	1.0561
1982	6.4540	0.7922	1.2075	0.9729	1.0348
1983	7.2964	0.8527	1.2996	0.9701	1.0318
1984	8.1615	0.9357	1.4262	0.9656	1.0271
1985	8.5972	0.9660	1.4724	1.0147	1.0793
1986	7.3947	0.7901	1.2042	0.9915	1.0546
1987 (1Q)	7.0355	0.7198	1.0972	0.8755	0.9312
1987 (2Q)	6.7112	0.6849	1.0439	0.8695	0.9249

Above 1.00 = undervalued
Below 1.00 = overvalued

Chart 16

Year	Foreign Assets (Mln US$)	CURRENT ACCOUNT As % of GNP %	CUMULATIVE 12 QTR. Current Account (Mln US$)
1970	893	-2.1	-106
1971	1061	-4.1	-640
1972	1248	-0.4	-827
1973	1514	-1.9	-950
1974	1769	-4.8	-1542
1975	2150	-8.8	-3961
1976	2042	-12.2	-7342
1977	1928	-14.3	- 11258
1978	2785	-5.3	-10883
1979	3560	- 2.3	-8181
1980	3909	1.9	- 2049
1981	4725	3.9	2231
1982	5232	1.2	3937
1983	4732	3.7	4825
1984	6831	5.5	5386
1985	8606	5.1	7888
1986	5978	- 7.9	453

Chart 17

HARD CURRENCY COVER (In millions of U.S. Dollars) 9482

Reserves * + Previous 12-months curren Account ***= 9482/13751 = 68.9%

(Reserves + 12-months C/A) /Ml ** = 9482/42289 =

(Reserves + 12-months C/A)/ Broad Money ** = 9482/42289

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

Figures in millions of U.S. Dollars

	Ml (Converted to U.S. Dollars)	Broad Money (Converted to U.S. Dollars)
1977	7.199	21.631
1986 (Dec.)	13,751	42.289
% Increase (decrease)	91%	95%
Corresponding % increase in the United States	108%	140%

(a) 1985 Imports as percentage of GNP 26.90%
(b) 1976 - 1985 Imports as percentage of GNP 29.29%
1985 /1976 - 198 7 average) = (a)/(b) = .9184

Source: IFS

Rates **Chart 18**

Spot	1 Month	3 Month	6 Month	12 Month
6.4275 6.4375	6.4655 - 6.4515	6.5445 - 6.5585	6.6515- 6.6675	6.8300- 6.8500

Friedberg Capital Markets

Danish krone

The Danish krone is a member of the European Monetary System (EMS). As such it parallels very closely the movement of the deutsche mark.

From January 1984 to the *present* the DKr has depreciated by 6.5% against the DM but appreciated 53% against the US$ (see Chart 19). DKr bonds, however, pay as much as 3.8% over DM bonds, making a DKr investment extremely attractive, if one believes as we do, that the DKr is not likely to depreciate any further against the DM.

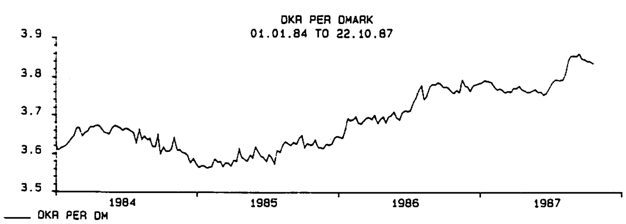
We offer the following DKr issue:

World Bank 9¾% 20/11/92

Yielding 10.35%, subject to change.

Rating: AAA

Chart 19 — Exchange-rate movements in relation to the Danish krone



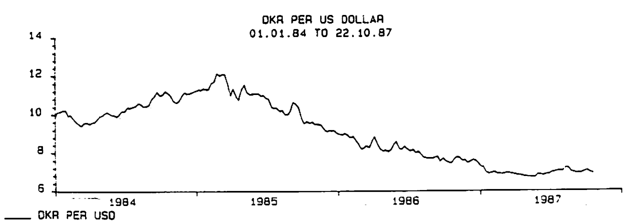


Chart 20

Foreign Currency Bonds

DATE: November 19, 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%	99 5/8 -	100 5/8	17.23	16/6/87-16/6/88
HONDA INT'L 20/9/89 16 3/8%	97 1/4 -	98 1/4	17.45	20/9/87-20/9/88
HONDA INT'L 28/5/90 16%	96 -	97	17.21	28/11/86-28/5/88
TOURIST HOTEL CORP. (N.Z.) 4/6/93 zero coupon	44 -	45	15.56	matures 4/6/93
BANK OF NOVA SCOTIA 15/9/89 18½ RRSP eligible	100 1/2 -	101 1/2	17.30	15/9/87-15/9/88
WELLS FARGO (semi-ann.) 12/5/89 16 1/8%	98 1/4 -	99 1/4	17.40	12/11/87-12/5/88
KODAK (semi-ann.) 15/2/89 17%	100 3/8 -	101 1/8	16.50	15/8/87-15/2/88
TORONTO DOMINION 2/4/90 18% RRSP eligible	99 1/2 -	100 1/2	17.54	2/4/87- 2/4/88
AUSTRALIAN DOLLAR DENOMINATED BONDS				
CAN.IMP.BANK OF COMMERCE 13/3/91 13% RRSP eligible	95 3/8 -	96 3/8	14.38	13/3/87-13/3/88
DANISH KRONE DENOMINATED BONDS				
WORLD BANK 20/11/92 9 3/4% RRSP eligible	97 -	97 3/4	10.35	20/11/86-20/11/87
DEUTSCHE MARK DENOMINATED BONDS				
GOVT. OF BELGIUM 29/4/96 5½%	92 1/2	93 1/4	6.56	29/4/87-29/4/88
QUEBEC HYDRO 1/5/96 5½ RRSP eligible	94 1/8	94 7/8	6.30	1/5/87- 1/5/88
SWISS FRANC DENOMINATED BONDS				
GOVT. OF AUSTRALIA 30/10/98 5%	101 1/4 -	102	4.76	30/10/87-30/10/88
JAPANESE YEN DENOMINATED BONDS				
GOVT. OF CANADA 23/7/93 5 5/8% RRSP eligible	103 -	103 3/4	4.85	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)	100.11	100.41	8 3/16%	7/1/88

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

Chart 21

Breakeven exchange rates for US$ — based investor

This analysis shows a "snapshot" of the relationship between interest rate differentials and rates of exchange. The breakeven rate measures how far the foreign currency has to devalue (for NZ$, A$) or revalue (for DM, SF, JY, DKR), before the interest rate advantage/disadvantage is overcome by currency depreciation/appreciation. **Bond yields and rates of exchange as of November 19, 1987.**

	U.S. $	NEW ZEALAND $	AUSTRALIAN $	DEUTSCHEMARK	SWISS FRANC	JAPANESE YEN	DANISH KRONE
2 year	7.70%	Honda 16⅜% 20/9/89 Yields 17.45% (.519 NZ/US)**					
3 year	7.96%		C.I.B.C. 13% 13/3/91 yields 14.38% (.584 A$/US)				
4 year	8.21%						
5 year	8.34%						World Bank 9¾% 20/11/92 yields 10.35% (7.10 US/DKR)
6 year	8.47%	Tourist Hotel Corp. 0% 4/6/93 yields 15.56% (.489 NZ/US)				Canada 5⅝% 23/7/93 yields 4.85% (110.09 US/JY)	
9 year	8.73%			Belgium 5% 29/4/96 Yields 6.52 (1.397 US/DM)			
11 year	8.85%				Australia 5% 30/10/98 yields 4.76% (.904 US/SF)		
Spot Exchange Rate	N/A	.6179	.6947	1.6805	1.3785	135.22	6.4812

**For example, in parentheses, since a US$ based investor would receive 975 basis points (1745-770) by holding the Honda 16⅜% bond, the NZ$ can depreciate to .519 NZ/US from the present spot exchange rate of .6179 NS/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 coupons are reinvested.

Forex Rates & Update

Currency	*Spot*	*3-Month*	*12-Month*	*Comments vis à vis US$*	*Comments vis à vis DM (Spot DM: 1.6800)*
*Belgian franc	35.10-35.20	35.02-35.08	34.70-34.95	Liquidate	Remain neutral
*Danish krone	6.4775-6.4875	6.5140-6.5300	6.6090-6.6375	Liquidate	Remain long
*Dutch guilder	1.8890-1.9010	1.8800-1.8820	1.8420-1.8450	Liquidate	Remain short
Greek drachma	130.90-131.00	135.30-137.00	145.90-155.00	Remain short	Remain short
Hong Kong dollar	7.7600-7.7700	7.6900-7.7050	7.6200-7.6700	Sell 12 months at 7.65 to US if available	
*Italian lira	1234-1235	1246-1250	1281-1288	Liquidate	Remain short
Kuwaiti dinar	.27920-.27840	.27675-.27740	.27726-.27408	Neutral	Remain short
Malaysian ringgit	2.4950-2.4960	2.4780-2.4820	2.4250-2.4460	Neutral	Neutral
New Zealand dollar	.6185-.6205	.6025-.6065	.5655-.5725	Remain long	Neutral
*Portugese escudo	136.00-136.50	138.00-140.00	141.00-150.00	Liquidate	Neutral
Saudi Arabian riyal	3.7500-3.7505	3.7330-3.7365	3.7140-3.7185	Remain short	Remain short
Singapore dollar	2.0250-2.0300	2.0090-2.0150	1.9825-1.9925	Neutral	Neutral
*Spanish peseta	113.00-113.20	114.90-115.40	119.00-120.20	Liquidate	Neutral
*Swedish krona	6.07-6.08	6.10-6.12	6.18-6.20	Liquidate	Neutral
Venezuelan bolivar	31.50-31.70	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

Tuesday, October 27: The market letter is in the mail. No changes or new recommendations.

Flash update, Monday, November 2, 9:55 a.m.: As we said on October 20 on our Hotline, the stock market has made a significant bottom. We expect the coming rally to be very sharp. If you have the stomach to ride out the market's incredible volatility without tight stops, we recommend you buy December S&P at market levels. A trend reversal would occur on closes below 220.00, basis spot.

Flash update, Tuesday, November 3, 10:45 a.m.: Sell March T-bonds at market, risking 8714 stop, close only.

Tuesday, November 3: There were two flash updates this week.
1) On Monday, Nov. 2, 9:55 a.m., we advised going long the stock market for those able to ride out the market's incredible volatility without tight stops. A trend reversal would occur below 220, basis spot.
2) On Tuesday, November 3, 10:45 a.m., we advised selling March T-bonds with a stop of 8714, close only.

Friday, November 6: 1) You are long the December S&P as of Monday a.m. flash update. A trend reversal would occur below 220, basis spot.
2) Liquidate short Danish krone/long deutsche mark cross trade and reverse it. Therefore we now recommend buying Danish krone against the sale of deutsche mark.

Tuesday, November 10: No changes or new recommendations.

Flash update, Tuesday, November 12: Sell March T-bonds at market, risking 8927 stop, close only.

Friday, November 13: 1) For the benefit of our subscribers, we are repeating a very important message: We are expecting a very strong and dramatic rise in stock prices to commence immediately. We have advised our subscribers to go long S&P futures if they have the stomach for the high volatility present in today's market. Risk a close below 220, basis nearest contracts.
2) We sold T-bonds as of last night's flash update, reinstating short positions. Place initial stops at 8927, basis March, close only. No other changes.

Tuesday, November 17: Two new recommendations.
1) Raise stops in Japanese yen, deutsche mark and Swiss franc to 7240, 5785, and 7047, respectively, basis December, close only.
2) Raise stops in sugar to 724, basis March close only.

Flash update, Friday, November 20, 10:45 a.m.: Liquidate long DM, SF, and JY positions at market, accepting handsome profits.

Friday, November 20: One change this week. As of our flash update this morning, we have liquidated our long DM, SF, and JY positions.

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