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Overheating, inflation, recession: A classic pattern

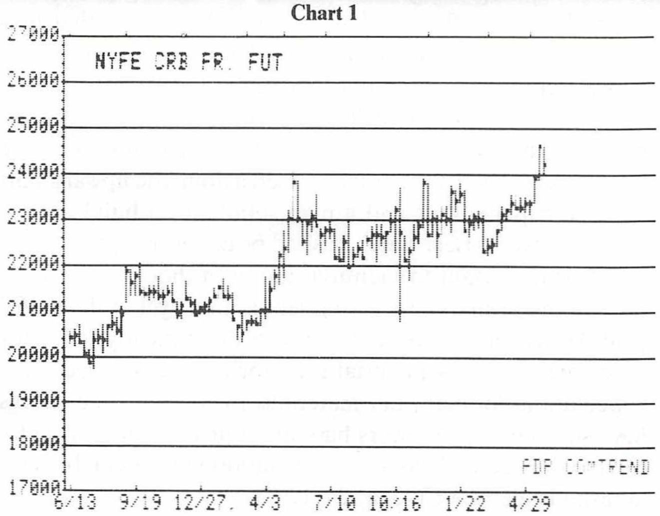
The growing determination (and, thus far, success) of the G-7 in defending present parities has shifted trading interest to two other arenas: interest rates and commodities.

It is a truism that forex stability, absent an iron-clad commitment to fixed exchange rates — and a history to prove this commitment — shifts the burden of financial instability to interest rate markets. Thus, pressure on foreign exchanges and/or inflation leads to intervention and rising interest rates. Pressure, in turn, arises out of a fundamental disequilibrium: excess spending.

Policy failure

Allowing the exchange rate to fall should shrink incomes and redirect trading activity from the import to the export side of the ledger. In an economy with a relatively small external sector, such as the US, and operating at full capacity, neither effect is obtained. Even allowing for the very minor — if any — improvement in trade achieved to date, the policy of deliberately encouraging the US dollar to fall by as much as 50% has failed miserably.

Chart 1



Since excess spending can be reduced only via increased savings, it is obvious that pressure can be removed only via higher interest rates.

The semi-credible commitment to target zones has lifted some of the pressure on the US dollar but has done little to remove the symptoms of excess spending. As a result, commodity inflation has begun to run rampant. The CRB index (see Chart 1 and discussion) hit a new, 12 month recovery high last week. *The Economist's* "All Items Dollar Index" soared 9.6% last month, and it stands 44.8% above last year at this time.

Two sides of the same coin

What is more, this simple analysis permits us to see that trade deficit and inflation are two sides of the same coin. A large trade deficit satisfies excess domestic spending. Slow imports (via tariffs, devaluation, or quotas) and accelerate exports (via devaluation or subsidies), and you will, all else remaining equal, increase inflation. A higher rate of inflation will finally succeed in cutting back spending, not without *eventually* precipitating a recession (see next article).

As we stated on the eve of the crash, we are in the midst of a boom that gives no signs of letting up. It is now the turn of prices and interest rates to rise, finally bring about the much-needed adjustment.

In this issue

The bear market in stocks is groping to find an intermediate bottom, so we buy index puts. The copper market is poised for another attempt at the highs, and we stay long calls. Platinum has been good to us, so we retain our positions. And wheat is getting set for a potentially tight situation — we're long. Contributions by Albert D. Friedberg, Steve H. Hanke, Daniel A. Gordon, and Michael D. Hart.

THE ECONOMY

Remembrance of things past

In economics, as in other fields of inquiry, it is prudent to reflect on things past. Of late, the early 1970s have caught our attention because the present seems to be unfolding in a manner that bears some resemblance to that earlier period. To refresh your memories, recall that in 1973, prices rose more rapidly than they had at any time since the Korean war. From December 1972 to December 1973 the consumer price index rose 9% and the wholesale price index 18%.

This surge in inflation was generated by a variety of factors: the simultaneous upsurge in demand in the United States and in foreign countries, the shortfall in agricultural production of 1972 and 1973, the decline in the international exchange value of the dollar, the capacity problems in raw materials industries, the Arab oil embargo and consequent increase in petroleum prices, and the slowdown in productivity and quickening in the rate of increase in compensation per man-hour, which resulted in a sharp rise in unit labor costs. By November 1973, the economy had entered a significant recession that was accompanied by increasing inflation. It lasted until March 1975.

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To begin our analysis of the present, consider our supply-side spread model (for a detailed discussion, see: *FC&CC* Nov. 22, 1987). The model measures the difference (spread) between the "value" of output produced and the "cost" of inputs used to produce output.

On the output side (the value side) of the spread, we don't have a direct measure of 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 2).

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

Chart 2 shows that our economy-wide spread model has performed well. Since 1973, it has signaled future economic growth and contraction with a high degree of reliability, forecasting expansions and contractions with nearly equal precision. Of particular note is the fact that, contrary to most other forecasts, the supply-side spread model was signalling economic strength in the fourth quarter of 1987 and the first quarter of 1988.

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With rather healthy supply-side spreads, it is clear that economic growth will continue, at least for the near term. This implies that capacity utilization in US manufacturing will continue to grow as it has over the past year. Indeed, at 82.7 in April, the factory operating rate is at its highest level during the present expansion. However, the current rate, when judged over a longer period, cannot be viewed with great alarm. For example, the present rate is well below the 87.7% rate of October 1973 or the 86.5% rate that was reached in late 1978.

But this isn't the end of the capacity utilization story. If we decompose the flow of manufacturing activity into those industries that are producers of materials or raw inputs — the "primary processors" — and those that build more sophisticated products — the "advanced processors" — we obtain a different story.

Over the past two years, there has been a dramatic divergence in operating rates between the primary processors (metals, textiles, paper, chemicals, petroleum, rubber, and other industrial materials) and so-called advanced processors that produce complex items well beyond the commodity-based stages of production. In April the primary processors' capacity utilization rate was 87.1%, which was 6.0% above the reading for advanced processors (the largest gap in 32 years).

Not only is the rate for primary processing high but also the gap between it and that for advanced processors is increasing. This and its comparison to the 1972-73 period looks ominous — especially since the earlier reading presaged a severe bout of inflation. The extreme divergence that now exists between primary and advanced processors represents a classic set-up for supply bottlenecks and some unexpected up-ticks in inflation. Recall that this is precisely what happened in the early 1970s, when shortages and intense price pressures in primary materials caused a dramatic upward shift in price expectations and a mad scramble to build up raw material inventories, which pushed prices even higher.

It is important to mention that even though utilization rates in the primary processing sector aren't yet at their 1973 peak levels, rates have moved up so dramatically that they have eaten into raw material inventories and changed price expectations for many raw materials. In consequence, prices have shot up as processors have attempted to build inventories, so that desired stock to consumption ratios can be reestablished (see *FC&CC* May 24, 1987).

With continued upward price pressure on raw materials, wages and other costs, which have been well behaved, will become, of course, harder to contain. Also worth mentioning is the fact that supply bottlenecks will make it more difficult to continue expanding exports at their current high rates. This will make it more difficult to turn the corner on the US trade deficit.

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If potential capacity constraints weren't enough, labor markets look as though they could spell trouble, too. The April employment report showed unemployment at 5.4%, a 14-year low. Also, initial unemployment claims have trended downward, and there has been a sizeable increase in the hours worked and overtime hours. These by themselves are not too disturbing because wages are relatively insensitive to labor market tightness, with the exception of those in some low-wage sectors.

However, wages become much more sensitive to labor market tightness when the tightness is coupled with falling real wages (inflation rates that exceed wage increases). Under these conditions, labor perceives that it has been unfairly treated and demands higher wages. These demands are satisfied because the labor markets are tight. Since real wages have been falling, we can anticipate that higher wage settlements will follow as they did in the early 1970s. In fact, the employment cost index registered its first acceleration in several years during the first quarter of 1988, increasing by 4.1% on a year-over-year basis.

With increases in employment, hours worked, and overtime, it will be difficult to sustain productivity growth as less productive labor is employed at the margin. Also working against productivity growth will be the fact that less productive plant and equipment will be used as firms continue to increase capacity utilization.

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The combination of faster wage growth and slower productivity gains will push unit labor costs upward. This spells trouble because higher unit labor costs will either be passed along to higher prices for final goods and services, which would be inflationary, or they won't be passed along, which would squeeze the supply-side spreads and lead to a recession.

Whether higher unit labor costs will be passed along or not is still an open question. To date, even though the foreign exchange value of the dollar has fallen, import prices haven't increased too much. The lead article in the May 1988 issue of the *Federal Reserve Bulletin* suggests that this has resulted because foreign firms' costs have not been rising as fast as inflation in foreign countries. If this weren't enough, foreign firms had unusually high profit margins before 1985, when foreign currencies began to appreciate. In consequence, foreign firms have not been forced to pass foreign currency appreciation through to export prices on a one-to-one basis. In fact, the pass-through has been rather modest.

Lacking dramatic import price increases, there has been a great deal of international competition in product markets. This has made it difficult for US producers to increase prices. If international producers continue to refrain from passing the increase in the value of their currencies through to prices of goods they export to the US, US producers will not be able to pass along increased unit labor costs. In consequence, the supply-side spreads will narrow and turn negative. This will result in a recession.

Alternatively, if foreigners engage in more pass-through of their currency appreciations, import prices will rise and US producers will face less foreign price competition. Hence, domestic producers will pass along cost increase and an inflationary boom will occur.

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Our analysis suggests the following sequence of events, a sequence that is reminiscent of that which occurred in 1973:

1. Supply-side spreads are wide and the economy is strong, with capacity utilization (particularly in primary processing) at high rates.
2. Commodity prices are rising more rapidly than general measures of inflation.
3. Labor markets are tight and real wages are falling.
4. Labor will demand and receive higher wages.
5. Productivity will slow and turn negative.
6. As a result of (4) and (5), unit labor costs will rise.
7. With unit labor costs rising faster than product prices plus productivity, the supply-side spreads will be squeezed and turn negative.
8. The economy will slide into a recession.

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It is interesting to note that the business cycle sequence above does not include a mention of monetary policy. We turn now to this important topic.

Early in 1973, the Federal Reserve began to "snug" monetary policy. This snugging became tightening by late 1973, after the recession had begun. In 1974, with inflation still rising,the Fed continued to tighten, even though a full-scale recession was on. Federal funds average 294 basis points above yields on 10-year treasury securities during 1974.

With the inflation genie out of the bottle and the supply-side squeeze on, we were headed for a recession in late 1973. The Fed's snugging reaction to rising commodity prices didn't bring on the recession. However, it, along with the later tightening, obviously contributed to a deeper and longer recession than would have occurred with a bit less tightening.

At present the Fed seems to be reacting to the recent rise in commodity prices by snugging. Recall that some of the Fed governors now claim to be targeting monetary policy to commodity prices. It appears that they are attempting to lean against these increases. For example, the positive gap between yields on 10-year treasury securities and federal funds has narrowed to 171 from 218 basis points during the past week.

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Our reflections bring us to the following disquieting conclusions: The economy contains the seeds of its own destruction. But before the recession begins, the boom and increased inflation will roll on.

Implications: Until the supply-side spreads become negative, stay long commodities and short bonds.

— Steve H. Hanke

Chart 2
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%

	Prices plus Productivity	Unit Labor Costs	Spread
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	4.6%	2.0%	+2.6%
1987 IV	5.9%	1.6%	+4.3%
1988	5.1%	2.1%	+3.0%

CRB INDEX

Commodities roaring ahead

The extraordinary strength displayed by the advance-decline line throughout the last half of 1987 and first half of 1988, has been fully vindicated: the Commodity Research Bureau index of commodity prices has broken out on the upside after stalling for almost 12 months just below the 240 level.

Our sense tells us that the CRB index will, ultimately, reflect the full extent of the 50% US dollar devaluation. Therefore, we expect the index to reach the 360 level in the not-too-distant future.

STRATEGY: *Retain long positions; raise stops to 232, basis cash index, close only.*

STOCK INDEXES

Hope springs eternal

From time to time, bears should test their power of conviction by searching for and then listing the most bullish arguments they can find. Here they are:

1. The extraordinary deceleration in M1 (see Chart 3) that began in 1987 seems to have come to an end, primarily because the M1 multiplier (see Chart 4) has finally broken its relentless and unexplained downtrend. In fact, Fed "action," better represented by the adjusted monetary base, has continued to grow all through 1987 at a remarkably steady 7.4% pace. If M1 deceleration was the cause of the stock market decline (it certainly did not affect the economy), then M1 reacceleration should be bullish.

2. The crash collapsed price-earning ratios by 50% (see Chart 5). Previous drops of this magnitude were associated with market bottoms. A recovery of this chart implies either the rise of stock prices *or a collapse* in earnings. Since the latter alternative is not being contemplated by most respectable economists — at least for the foreseeable future — it leaves us only the first alternative.

3. The bearish contingent is growing. nearly everyone believes we are in a bear market. *Investors Intelligence* latest reading: 29.8% bullish, 54.9% bearish. Contrarians will tell you that, *at the very least*, you are near a major rally if not a *bottom.*

4. The US dollar has stabilized. Foreigners may be more willing to purchase US financial assets now than just six months ago.

Are there any valid counterarguments? We think so.

In the first place, the Fed has given every indication, including raising the Fed funds target above 7 3/8%, that it wants to tighten. While M1 growth will catch up as the multiplier returns to a more traditional level, the Fed is likely to snug the growth of the adjusted monetary base so that ultimate M1 "reacceleration" will fall far short of the 1985-86 pace. Thus the bullish impact of increasing liquidity will be offset by the growing perception of a tightening policy.

We do not preclude, however, the possibility of a liquidity-induced *rally* if the perception arises that a tightening move has been completed and is sufficient.

As to point no. 2, while our supply-side spread (see "Remembrance of things past") is still positive, indicating that profits are likely to remain healthy for the near term, a quick acceleration of commodity and wage inflation (that we foresee) is likely to turn the spread negative without too much warning. Coupled with the extremely high level of corporate leverage, *profits are likely to collapse* once the supply spread turns negative. At this point, p-e's will soar.

Argument no. 3 says that the stage is *being set* for a significant rally. It does not say when or, more importantly, *from what level.* Moreover, bear markets, by their very nature, are characterized by more bears than bulls — one cannot apply bull market standards (1975-87) to make a case for a move to new highs.

Finally, while it is true that the US dollar has stabilized, there is no reason to believe that foreigners will be more irrational than domestic investors if interest rates continue to rise: They are more likely to choose interest-bearing securities than equities.

A look at Chart 6 (which we have been reproducing for a number of months) tells us that the bear market is on course and just 2% below its indicated path. Massive rallies are *not* likely to occur from these levels.

In conclusion, the bear market is groping to find a new intermediate bottom that may challenge and even exceed the early December lows (221 on the S&P 500 and 1734 on the Dow Industrial). It will generate excessive pessimism as it falls far below its expected path (again, refer to Chart 6). At which point, a rally will take place.

STRATEGY: *Ideally, put options should be bought at or just above our "path" on Chart 6. Since we are about 2% below 258 and option premiums are still high, we suggest* selling *June 260 calls and* buying *June 250 puts for a net debit of 130 points. Cover June 260 calls if the cash index closes above 260.00.*

Chart 3

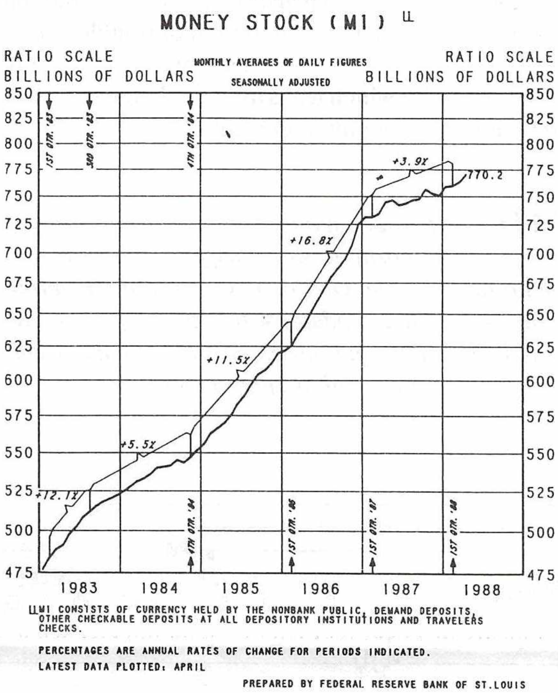


Chart 4

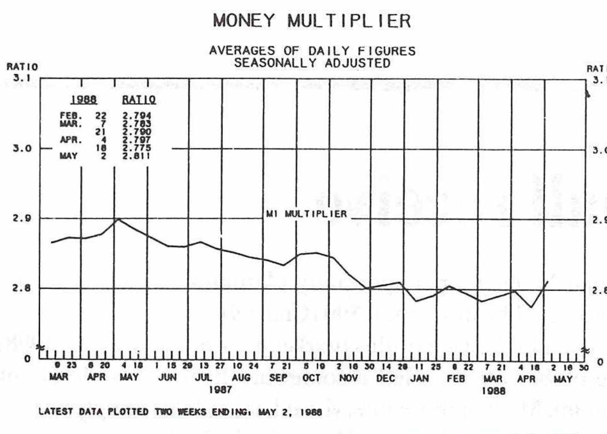


Chart 5

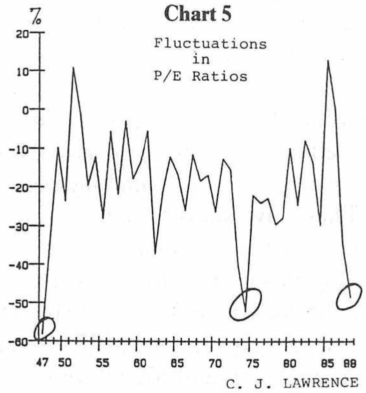


Chart 6

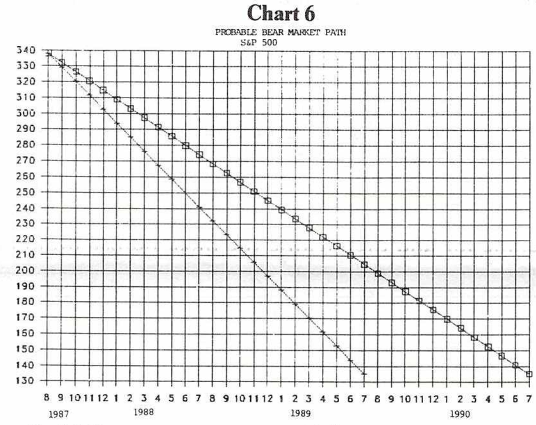
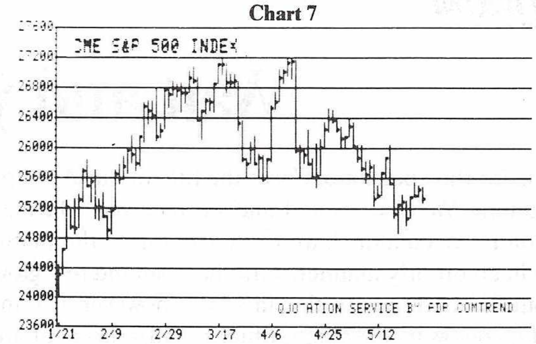


Chart 7



T-BONDS

Maintain puts

In line with our views expressed in the first two articles, we are short T-bonds via put options.

STRATEGY: *Maintain long positions in September 84 and 86 put options.*

COPPER

Another attempt at the highs

Copper's extremely wide swings of late have been a function of warehouse movement and expectations. A large drawdown into early May caused prices to spurt to 9720, basis July 88; more recently, an increase in combined LME and Comex stocks to 70,585 tonnes caused prices to ease to 88.50, basis July 88.

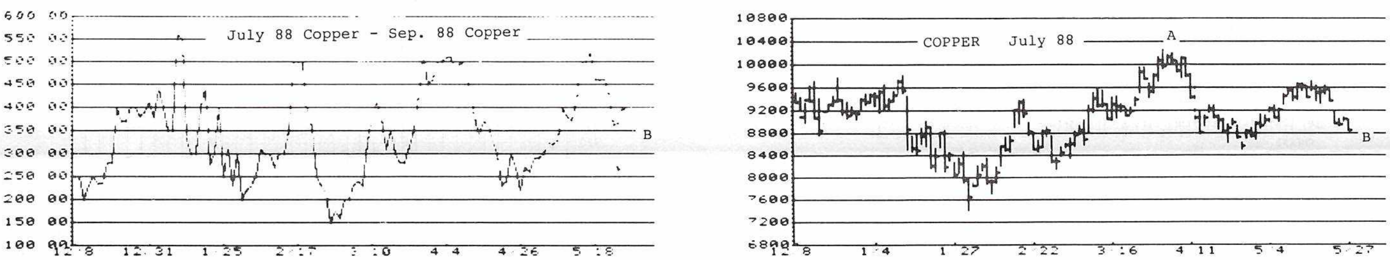
Throughout this strange warehouse stock behavior, backwardation widened in both London (to as much as £330, closing Friday at £170) and New York, with May expiring 800 points above July 88. These inversions belie the "warehouse story": Copper continues to be in very tight supply.

Corroborating this view, is the latest batch of statistics emanating from the American Bureau of Metal Statistics: US refinery inventory, as of April, stood at 72,900 tons compared with 77,000 tons in March and 87,300 tons in April. Crude and refined copper output in the US fell during April.

Chart 8 tells a revealing story: The July-September backwardation can be used, profitably, as a confirming factor to the outright July position: When it failed to confirm the "breakout" (point A), it was an early indiction of trouble ahead, At this time, futures appear a great deal weaker than the backwardation (point B), which leads us to think that the market is poised for another attempt at the highs.

STRATEGY: *After a number of unsuccessful attempts to establish a futures position, we managed in the last round to make a profitable trade. On Friday we advised reentering the long side (see Hotline Update) with close stops. We are still long July call options and advise buying September call options at the money or just above present levels.*

Chart 8



PLATINUM

Wait and you shall receive

"Waiting for the speculators" was the title of our April piece on platinum. Well, we waited and we received. During the past month, speculators have been arriving to the platinum market in an orderly manner, with the open interest growing by about 25%. Even with this increase, however, it remains about 17% below its 1987 high, which occurred in September. With increased speculative interest, platinum prices have moved up smartly, and more importantly, platinum's premium to gold has widened by more than $90 (Chart 9).

Even in the face of this market action, the May 16, 1988, issue of *Barron's* carried a somewhat bearish article about platinum. Most of those interviewed argued that supply is large enough to swamp demand. We find this thesis unconvincing. If there was so much platinum around, why has the market (spot vs. nearby futures) moved from contango (late 1987) to increasing backwardation?

As we pointed out in "Backwardation revisited" (*FC&CC* Dec. 20, 1987), widening backwardation means increasing commodity interest rates and tightness in spot markets. Under these conditions, someone somewhere desires a commodity and is willing to pay a positive commodity interest rate for a "commodity loan" (receipt of a commodity). The willingness of borrowers (buyers) to pay this interest rate is what motivates sellers (those who lend commodities) to push a commodity out of storage and into the spot market.

Rather than a surplus of platinum, there is a squeeze on physical supplies. This is reflected by platinum's increasing backwardation and the drawdown from stocks in New York and Zurich. This feature of the platinum market apparently has gone unnoticed by those interviewed in *Barron's*.

But who has been willing to pay positive commodity interest rates (premiums) to receive platinum? Where has the platinum gone? As we first pointed out in our March issue, the Nipponese have been willing to pay. In consequence, platinum has been squeezed out of stocks (at a price) and moved to Japan.

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Last week Johnson Matthey (J.M.), the respected British refiner and platinum fabricator with close ties with South African's largest producer, Rustenburg Mines, officially unveiled its 63-page annual report, which is simply titled "Platinum." J.M. has become more bullish since its "1987 Interim Review," which was published in November 1987. By J.M.'s reckoning, in 1987, platinum suplies fell short of demand and stocks were reduced to 220,000 ounces, which is the largest deficit recorded in the past 10 years. Moreover, 1987 was the third consecutive year of shortfall. J.M., unlike those interviewed in *Barron's*, projects that 1988 will also be a deficit year, and that 1989 and 1990 might fall into the red too.

The J.M. platinum supply-demand balance is consistent with our own views. What is puzzling is the price conclusion that J.M. draws from its supply-demand analysis. Even though the average price of platinum was $556 per ounce in 1987, $94 per ounce higher than 1986, J.M. concludes that the 1988 range will be $450 to $550 per ounce. Given J.M.'s projection of continued deficits, this price range simply doesn't make sense. It is much too low.

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For the near term, allow us to leave you with the following thoughts about the demand side of the platinum market.

1. **The Nipponese factor:** The Japanese continue to exhibit an unrelenting demand.

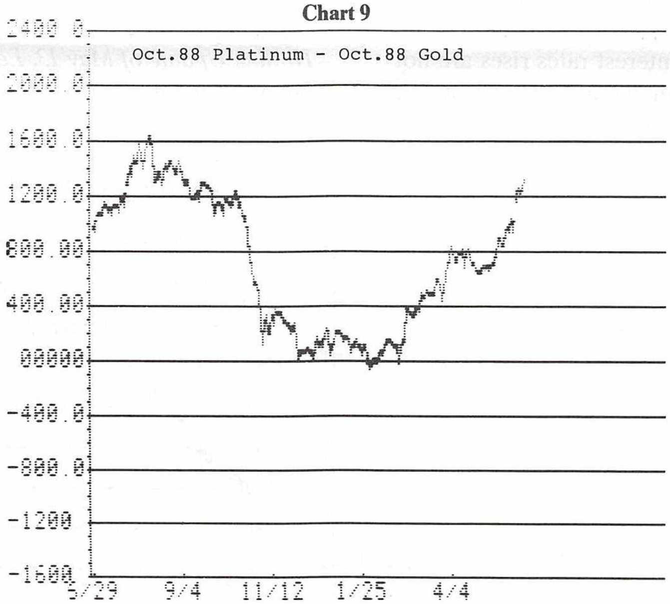
2. **The industrial factor:** The US economy continues to boom (see "Remembrance of things past" in this issue). If this weren't enough, the 24 industrial nations that are members of the OECD have increased their forecast of real GNP growth for the group to 3.0%. Their most recent forecast, which was made in May 1988, exceeds that which was made in December by 0.8%. In consequence, industrial use will clearly be much greater than many who have suffered from the post-October 19 syndrome had thought.

3. **The investment factor:** Platinum as an investment, particularly in large denominations (500 gram and 1 kilogram bars), has become a regular feature of this market. In consequence, J.M., for the first time, has quantified it separately in its demand estimates. This new segment of the market promises to give it an added boost.

STRATEGY: *Retain long platinum (2)/short gold (1) spread. Roll over positions to October '88 platinum and October '88 gold. Raise stops to $70/oz. platinum premium, on close only.*

— Steve H. Hanke

Chart 9



GOLD

Still weak relative to platinum (see Chart 9 and text) and CRB (Chart 10) but starting to strengthen against the world's hard currencies. In effect, gold has broken out of a 15-month downtrend *vis à vis* Swiss francs (Chart 11) and is very close to doing the same *vis à vis* Japanese yen (see Chart 12).

This behavior supports our view that trading interest has shifted away from currencies and moved to commodities.

STRATEGY: *We still prefer the long 2 platinum/short 1 gold and the long 1 CRB/short 2.5 gold spreads. Outright long gold positions should be protected with stops at 442, basis spot.*

Chart 10

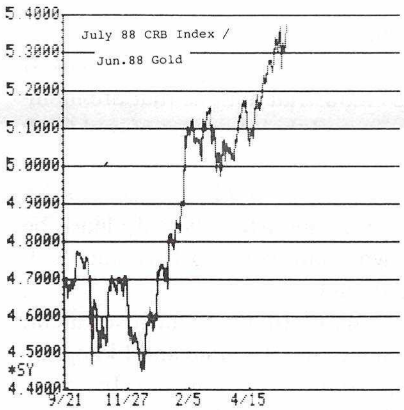


Chart 11

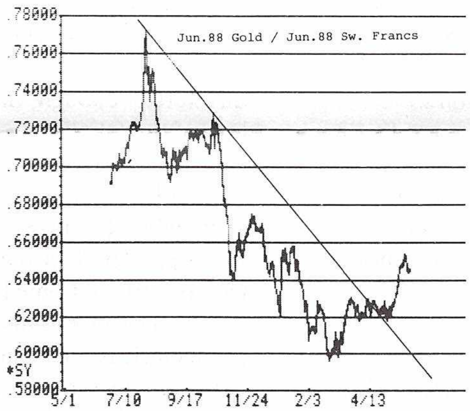


Chart 12

CANADIAN DOLLAR

Canuck buck on the way down

The growing European and Japanese belief that the US dollar was in the process of stabilizing, an advantageous yield differential *vis à vis* US money market rates (see Chart 13), and the prospects for a free trade agreement (expected to cause long-term capital inflows into Canada) conspired to lift the Canadian dollar to a four-year high against the US unit.

In coming weeks yield differentials *vis à vis* the US are likely to narrow somewhat as US interest rates rises are not followed by the Bank of Canada, which is already satisfied by the relatively high level of *real* domestic rates. Moreover, a high Canadian dollar, at this juncture may not be terribly convenient as the current account plunges into the red at an alarming rate of C$15 billion.

We believe that the Canadian dollar will ease in the near future.

STRATEGY: *We are short the Canadian dollar as per Hotline Update of May 13. Leave stops at 8125, basis September 88, close only.*

Chart 13

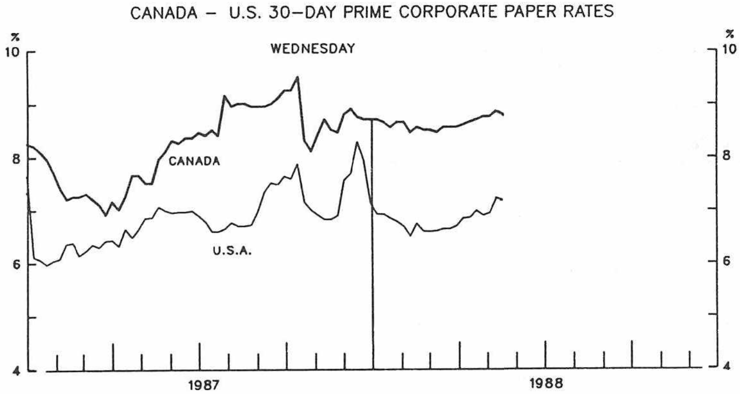
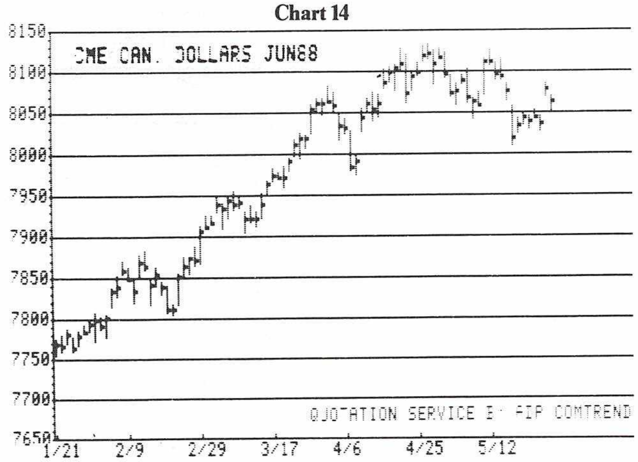


Chart 14



CURRENCIES

Dollar strength may be just a manifestation of the Deutsche mark's weakness as the DM/¥ and DM/Sterling cross rates collapse.

DM and other EMS currencies have weakened sufficiently to believe that a possible change in trend is in the making, more particularly, a further weakening of the DM and SF *vis à vis* the yen and Sterling.

STRATEGY: *Place stops on DM, SF, and other EMS currencies at DM1.74, close only (equivalently 58.10, basis September '88, on the IMM). Stops on Sterling should be placed at 1.8390, basis September '88, close only. Yen stops should be raised to 7980, basis September, close only.*

SUGAR

The boom-bust cycle

For some time, we have favored sugar (see *FC&CC* May 24 and July 26, 1987, and Jan. 24 and Feb. 21, 1988). Although we confess that we haven't traded this commodity in a brilliant manner, we have been on the right side of the market.

Allow us to explain the economic logic that dictates our sugar preferences. The long-run marginal cost of producing sugar for the world market is about 11¢ to 13¢ per pound. In the 1979-80 to 1981-82 period, prices exceeded these costs. This stimulated production, retarded demand, and increased the stocks-to-consumption ratio. In consequence, prices collapsed to levels that were much below long-run marginal costs, and as a result, stocks-to-consumption ratios have been falling since the 1982-83 market year.

This trend in the stocks to consumption ratio will continue until stocks reach uncomfortably low levels and prices move to levels that are well above long-run marginal costs. At that time, producers will have an incentive to increase supply, and demanders will have an incentive to conserve on their sugar use. The combination of these forces will result in a build-up in unwanted stocks, and prices will once again collapse to levels below long-run production costs. Then, sugar's boom-bust cycle will begin again.

This leads us to the following important conclusion about the sugar market: Sugar prices that are below the long-run production costs aren't sustainable; they must increase. However, when they rise, they will overshoot and move well above the long-run cost level. Sugar prices that are above long-run production costs aren't sustainable; they must fall. However, when they fall, they will overshoot and move well below the long-run cost level.

STRATEGY: *We are in the early stages of the boom phase of the sugar cycle. Reestablish long positions in the October contract. Place stops at 822, on close only.*

— Steve H. Hanke

WHEAT

Some food for thought

The wheat supply-demand picture turned favorable in the 1987-88 crop year (see Chart 17). One factor that has accounted for the dramatic reduction in stocks has been the aggressive US government selling of public inventories through the Export Enhancement Program (EEP). Under the EEP, the Commodity Credit Corporation (CCC) awards bonuses, in the form of certificates (redeemable for CCC government-owned wheat), to exporters. These certificates enable exporters to sell wheat to specified countries at prices below those of the US market.

To appreciate the importance of EEP, note that exports are up almost 60% from 1,004 million bushels in 1986-87 to a USDA projected 1,600 million bushels in 1987-88. Interestingly, our sales to the USSR and China are up to 623 million bushels, and sales to Eastern Europe are expected to be up with another 31 to 32 million bushels. Thus, rather shockingly, our total exports to the rest of the world, the noncommunist world, are actually down a bit this year from the depressed levels of last year.

All of the sales to the communist countries, the centrally planned economies, this year have been under the EEP. This has involved subsidies, in most cases, that have ranged from $1.00 to $1.20 per bushel, with recent sales at lower subsidy rates.

The EEP has stimulated the wheat market. With the election year upon us and the administration's new-found love feast with the communists, it has an incentive to continue pushing hard on EEP sales. In consequence, the ending stocks, as of June 1989, are estimated by the USDA to fall to less than one billion bushels. The last time this occurred was in the 1980-81 crop year, when the ending stocks were 989 million bushels and the price was $4.00/bushel.

If election year politics weren't enough of a reason to manipulate the wheat markets with EEP, the administration will find some help in rationalizing that policy from a variety of countries that have "special needs." India is an example. It had a disasterous crop (remember the big Indian drought). If this weren't enough, rice, which is a substitute for wheat, is in short supply; a fact that is attested to by rice prices that have soared by more than 100% over the past year. As a result, India has already sent a delegation to Washington to promote a big EEP deal.

The North African nations of Tunisia, Algeria, and Morocco — the first and traditionally large importers of EEP wheat — will probably also give the administration cause to pump up the EEP program and drain the US CCC reserves. The problem in this wheat consuming part of the world is a plague of locusts. The countries mentioned above are already treating these critters as an invading army. As a leading indicator of the magnitude of this problem, we note that Tunisia has recently tendered for 75,000 tons of wheat. What makes this tender of particular interest is the fact that it is for June delivery, a date that coincides with the Tunisian wheat harvest. It strikes us that this is a rather odd time for a Tunisian wheat import delivery.

All this politics and "special needs" mean that exports for 1988-89 could exceed th USDA estimate. In addition, the recent spot of dry weather has done some real damage to the 1987-88 winter wheat crop. Hence, the harvest of that crop might turn out to be less than the USDA estimate, resulting in a lower figure for the 1987-88 ending stocks. In short, wheat is getting set up for what could evolve into a very tight supply-demand situation.

STRATEGY: *We are now in the winter wheat harvest season. Normally, this would put downward pressure on the market. However, the recent dry weather has overcome this cyclical factor. Long wheat positions would be established by mid-June to take advantage of the harvest cycle. Buy December '88 wheat at 3.40 on temporary dips created by rains (remember that we are currently trading in a very tricky weather market). Place initial stops at 3.19-3/4, close only.*

— Steve H. Hanke

Chart 17

Wheat Supply/Demand

(millions of bushels)

	1981/82	1982/83	1983/84	1984/85	1985/86	1986/87	April 1988 USDA Estimate 1987/88	May 1988 USDA Estimate 1988/89
Beginning stocks	989	1,159	1,515	1,399	1,425	1,905	1,821	1,231
Production	2,785	2,765	2,420	2,585	2,425	2,092	2,105	2,170
Total supply	3,777	3,932	3,939	4,003	3,866	4,018	3,941	3,416
Total domestic use	847	908	1,112	1,154	1,046	1,193	1,110	1,120
Exports	1,771	1,509	1,429	1,424	915	1,004	1,600	1,500
Total use	2,618	2,417	2,540	2,578	1,961	2,197	2,710	2,620
Ending stocks	1,159	1,515	1,399	1,425	1,905	1,821	1,231	796
Ending stocks as % of use	44.3%	62.7%	55.1%	55.3%	97.1%	82.8%	45.4%	30.4%

FRIEDBERG CAPITAL MARKETS

Chart 18

Foreign Currency Bonds

Date: May 26, 1988

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 ANN. YIELD TO MTY	LAST PAY DATE - NEXT PAY DATE
NEW ZEALAND DOLLAR DENOMINATED BONDS				
COCA COLA 16/06/89 18%	101 1/2	102 1/2	15.17	16/06/87-16/06/88
HONDA INT'L 20/9/89 16 3/8%	100 7/8	101 5/8	14.70	20/09/87-20/09/88
HONDA INT'L 28/5/90 16%	101 3/8	102 1/8	14.68	28/11/86-28/05/88
TOURIST HOTEL CORP.(N.Z.) 4/6/93 zero coupon	49	51		matures 04/06/93
BANK OF NOVA SCOTIA 15/9/89 18 1/2% RRSP eligible	102 1/4	103 1/4	15.28	15/09/87-15/09/88
WELLS FARGO (semi-ann.) 12/5/89 16 1/8%	99 3/4	100 3/4	15.79	12/05/88-12/11/88
KODAK (semi-ann.) 15/2/89 17%	100 3/4	101 3/4	14.69	15/02/88-15/08/88
TORONTO DOMINION 2/4/90 18% RRSP eligible	104 1/4	105	14.59	02/04/88-02/04/89
AUSTRALIAN DOLLAR DENOMINATED BONDS				
CAN.IMP.BANK OF COMMERCE 13/3/91 13% RRSP eligible	98 1/4	-		13/03/88-13/03/89
WORLD BANK 15/3/93 12 3/4% RRSP eligible	102 5/8	103 3/8	11.75	15/03/88-15/03/89
CMNWLTH BANK OF AUSTRALIA 01/07/94 14%	104 7/8	105 5/8	12.61	01/07/87-01/07/88
DANISH KRONE DENOMINATED BONDS				
WORLD BANK 20/11/92 9 3/4% RRSP eligible	99	99 3/4	9.79	20/11/87-20/11/88
STOCKHOLM 10/11/91 10 5/8%	101 1/4	102	9.87	10/11/87-10/11/88
DEUTSCHE MARK DENOMINATED BONDS				
GOVT.OF BELGIUM 29/4/96 5 1/2%	96 1/4	97	5.99	29/04/88-29/04/89
QUEBEC HYDRO 1/5/96 5 1/2 RRSP eligible	95 1/2	96 1/4	6.11	01/05/88-01/05/89
SWISS FRANC DENOMINATED BONDS				
GOVT.OF AUSTRALIA 30/10/98 5%	101 3/4	102 1/2	4.69	30/10/87-30/10/88
JAPANESE YEN DONOMINATED BONDS				
GOVT.OF CANADA 23/7/93 5 5/8% RRSP eligible	104.05	104.80	4.55	23/07/87-23/07/88

U.S.DOLLAR DENOMINATED FLOATING RATE NOTES

ISSUER	MAT.DATE	COUPON	BID	OFFER	CURRENT COUPON	LAST PAY DATE - NEXT PAY DATE
UNITED KINGDOM	7/10/92	3 mo.LIBID (quarterly)	99.79	100.09	6 15/16%	07/04/88-07/07/88
UNITED KINGDOM	24/9/96	3 mo.LIBID-1/8	99.87	100.17	6 5/8%	24/03/88-24/06/88
BANCO CENTRAL (restructured) DE CHILE		12 mo. LIBOR + 1 1/8 (annually)	62½	66½	9.0625%	20/01/88-20/01/89

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

Chart 19
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$, A$, DKr) 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 May 27/88.**

	U.S. $	NEW ZEALAND $	AUSTRALIAN $	DEUTSCHEMARK	SWISS FRANC	JAPANESE YEN	DANISH KRONE
1 year	7.67%	Wells Fargo 16⅛% 12/5/89 Yields 15.79% (.6486 NZ/US)					
2 year	8.26%	Honda 16% 28/5/90 Yields 14.68% (.6283 NZ/US)					
4 year	8.66%						World Bank 9¾% 20/11/92 Yields 9.79% (6.7744 U$/Dkr)
5 year	8.80	Tourist Hotel Corp. 0% 4/6/93 Yields 14.40% (.5839 NZ/US)				Canada 5⅝% 23/7/93 Yields 4.55% (106.04 US/JY)	
6 year	8.92		Commnwlth Bank 14% 1/7/94 Yields 12.61 (0.7035 A$/USD)				
8 year	9.12			Quebec Hydro 5½% 1/5/96 Yields 6.11 (1.4778 US/DM)			
10 year	9.27				Australia 5% 30/10/98 Yields 4.69 (1.0859 US/SF)		
Spot Exchange Rate	N/A	0.6975	0.8060	1.7168	1.4339	124.89	6.5350

Chart 20
Foreign currency bond investment yearly performance
April 30/87-April 29/88
For a US$ Based Investor

Had you invested on April 30/87 in:	% appreciation/ depreciaiton due to currency fluctuation	% appreciation/ depreciation due to price of bond (interest rate fluctuation) % currency appreciation	Nominal Coupon % currency appreciation	Total Return in US$ *
Wells Fargo 16 1/8% 5/12/89 NZ$	+ 15.86	+9.32	+18.68	+43.96%
Quebec Hydro 5 1/2% 1/5/96 DM	+6.90	+3.55	+5.88	+16.33%
Canada 5 5/8% 23/7/93 JY	+12.31	-2.47	+6.32	+16.16%
Australia 5% 30/10/98 SF	+5.39	+1.49	+5.27	+12.15%
C.I.B.C. 13% 15/3/91 A$	+7.78	+6.59	+14.01	+28.38%

*Assumes that all coupons were reinvested fully.

Chart 21
Foreign currency bond investment yearly performance
April 30/87-April 29/88
For a Cdn$ Based Investor

Had you invested on April 30/87 in:	% appreciation/ depreciaiton due to currency fluctuation	% appreciation/ depreciation due to price of bond (interest rate fluctuation) % currency appreciation	Nominal Coupon % currency appreciation	Total Return in Cdn$ *
Wells Fargo 16 1/8% 5/12/89 NZ$	+6.88	+2.17	+17.23	+26.28%
Quebec Hydro 5 1/2% 1/5/96 DM	+1.78	+3.38	+5.60	+10.76%
Canada 5 5/8% 23/7/93 JY	+3.23	-2.72	+5.81	+6.32%
Australia 5% 30/10/98 SF	+3.24	+1.46	+5.16	+9.86%
C.I.B.C. 13% 15/3/91 A$	+.95	+6.69	+13.12	+20.76%

*Assumes that all coupons were reinvested fully.

THE EXOTICS

Kuwaiti dinar

This super-conservative Arab state, now holding the world's largest state treasure (US$90 billion) continues to allow for a gradual and orderly process of deflationary cutbacks in the standard of living. Per capita GDP has declined from Kd4016 in 1984 to Kd2650 in 1987. Narrow money supply has declined from Kd1290 million at the end of 1981 to Kd1017 million in January 1988.

Practically all of Kuwait's exports and budgetary revenues come from oil. As a result, both of these items have fallen in the same proportion as petroleum prices. The intention of the ruler is to adjust the economy to the level of petroleum revenues. In view of the country's physical inability to diversify (sand, sand, sand), this course of action seems to offer the safest results.

STRATEGY: *In October 1986 we recommended the sale of Kuwaiti dinars against the purchase of DM and have maintained this position to date. It has proven to be highly profitable, as the Kuwaiti dinar depreciated against the DM by 8.76%. Remain neutral against the dollar, accept profits against the DM, and move to the sidelines.*

Chart 22
Kuwati dinar rates

Spot	1 Month	3 Month	6 Month	12 Month
.27465 - .27480	.27422- .27452	.27331- .27388	.27176- .27275	.26819- .26992

FOREX RATES & UPDATE

Currency	*Spot*	*3-Month*	*12-Month*	*Comments vis à vis US$*	*Comments vis à vis DM (Spot DM: 1.7150)*
Australian dollar	.8065-.8075	.7962-.7975	.7697-.7717	Remain long, raising stops to .7650, basis cash, good anytime	Neutral
Belgian franc	35.70-35.75	35.55-35.65	34.83-35.18	Remain long**	Neutral
Danish krone	6.53-6.54	6.55-6.57	6.59-6.62	Remain long**	Remain long
Dutch guilder	1.9195-1.9205	1.8926-1.9040	1.8507-1.8533	Remain long**	Remain short
Greek drachma	137.00-137.10	138.60-140.90	145.00-153.70	Remain short	Remain short
Hong Kong dollar	7.8150-7.8160	7.8015-7.8055	7.7300-7.7510	Remain short	Neutral
Italian lira	1270-1271	1278-1281	1301-1309	Remain long**	Remain short
Irish punt	1.5595-1.5605	Not available	Not available	Neutral	Neutral
Malaysian ringgit	2.5845-2.5855	2.5635-2.5665	2.5045-2.5155	Neutral	Neutral
New Zealand dollar	.6970-.6980	.6820-.6850	.6515-.6575	Neutral	Neutral
Norwegian krone	6.21-6.22	6.29-6.30	6.48-6.51	Remain long**	Neutral
Portugese escudo	139.40-139.80	140.40-141.80	143.90-147.30	Remain long**	Remain long
Saudi Arabian riyal	3.7500-3.7505	3.7495-3.7515	3.7470-3.7510	Remain short	Remain short
Singapore dollar	2.0165-2.0175	2.0012-2.0027	1.9455-1.9515	Neutral	Neutral
Spanish peseta	113.15-113.35	113.75-114.05	115.25-115.75	Remain long**	Neutral
Swedish krona	5.93-5.94	5.97-5.98	6.03-6.06	Remain long**	Neutral

Explanatory Notes

**Liquidate these long positions should the $/DM rate move above 1.7400 on a New York Close.

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

Friday, April 29: The market letter is in the mail.
a) We have been extremely bullish on copper, yet we have warned that extreme volatility would make call options a better trade than futures. As a result, we advised the purchase of July calls. For those who only trade future, we twice advised the purchase of July '88, but twice we were stopped out. We still think copper is going a great deal higher. If you would like to try buying futures a third time, buy July at market and risk 85.00, good anytime. Otherwise, add to your existing options by purchasing July 90 and July 92 calls, at market.

Friday May 3: Repeat as above.

Friday, May 6: We recommended the purchase of either one September 86 or two September 84 T-bond options at market. We also remind you that your are long July copper call options and outright positions. You have a stop at 85.00, good anytime.

Tuesday, May 10: There are no changes or new recommendations. One reminder. On Friday, May 6, we recommended the purchase of either one Sept. 86 T-bond put or two Sept. 84 T-bond put options.

Friday, May 13: Two new recommendations. First, a low-risk, high-reward trade. Sell September C$ at market, risking 8125, on close only. Please note that the chances of getting stopped out are considerably higher than in our usual recommendations. Our target is a move down to the 77¢ area. Second, buy October sugar at market, risking 822, close only.

Flash update, Thursday May 17, 1:50 p.m.: There have been two significant events in the past few days.
1) The CRB has broken into new high ground as we have anticipated for quite some time. This means that investors should be particularly keen to be long commodities, especially those that we have been recommending.
2) Gold broke out on the upside of two-year downtrends against SF, DM and yen, indicating that its phase of underperformance relative to currencies is over. While we still think that near-term, both the CRB and platinum will outperform gold, modest long positions in gold are advisable — especially as a switch from currency positions, on an equal dollar basis.

Friday, May 20: A review of the outstanding positions established via the Hotline since the last market letter.
1) You are long July copper outright as of April 29. Raise stops to 8990, close only.
2) You are long September 84 and/or 86 T-bond put options as of May 6.
3) You are short September C$ with a stop of 8125, close only, as of May 13.
4) You are long October sugar with stops at 822, close only, as of Friday, May 13.
5) We suggested a switch from the long currency position to gold. For those who chose to retain currency positions, stops remain as in the market letter. For those who switched, place stops at 442, basis spot, close only, as of May 17.

Tuesday, May 24: Repeat of Friday's message with one change.
1) You are stopped out of copper as of today's close.
2) As above (Friday, May 20)
3) As above (Friday, May 20)
4) As above (Friday, May 20)
5) As above (Friday, May 20)

Flash update, May 27, 11:05 a.m.: Reinstate long positions in July copper, at the market. Place stops at 8750, close only. If there are no other changes, this will replace the regular Friday update. The market is closed Monday, so have a great weekend.

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