

FRIEDBERG'S

COMMODITY & CURRENCY COMMENTS

Friedberg Commodity Management Inc.



Volume 9, No. 7 August 1988

The dollar rules, again

While economists are busy fighting the last war, discussing the size of the upcoming US trade deficit number, forex traders are running away with the goods. In fact, their behavior signals the death of the trade deficit issue:

Not that the trade deficit will disappear any time soon: It won't *short of a US recession*. But it is no longer relevant. Why? Because the numbers are becoming smaller relative to GNP for the first time since 1981 (Chart 1). With nominal GNP growing at 8% per annum, an unchanged \$150 billion current account deficit will by necessity become ever smaller (in five years' time it will shrink to a modest 2% of GNP).

Traders are far more sensitive than economists to slight variations in trends, perhaps because they don't bother to work out long-term effects and consequences. Or perhaps because they realize the futility of extrapolating long-term trends. What matters to them is the, admittedly minuscule, change in direction. If the current account deficit is shrinking — at least in relative terms — then it can no longer be relevant — at least for the near future.

And there is more. It was government officials, economists, and journalists who developed the "overvaluation" theme — that the US trade deficit was caused or aggravated by an overvalued dollar.

From 1985 through 1987 the G7 pounced on the dollar in an effort to correct the imbalance. The "talking down" operation became so successful that it necessitated concerted central bank *buying* of dollars to stop what looked like a bottomless rout. But in fact, as we have repeatedly pointed out in past issues, their verbal manipulation accelerated a destabilizing speculative bandwagon effect that bore little connection to genuine *capital* flows.

Traders sold dollars because dollars were going lower, and dollars were going lower because at first the G7 believed that the dollar was overvalued and, later on, because it had been implanted in traders' heads that continuing trade deficits equated to a still overvalued dollar. A neat theory, except that by the end of 1987, it was beginning to wear thin. US imports were not falling, as they should have been if in fact the dollar devaluation had been producing the desired adjustment.

Disappointment with the results of this devaluation

caused the first weakening of the trade deficit/overvaluation linkage. The second, and more definitive, cause for dismissal of the theory came about in early 1988, as it became evident that the US trade balance was improving, *primarily because of a surge in exports*. Differential rates of economic growth had a lot more to do with US trade balances than exchange rate levels: A strong pickup in OECD countries' growth outside of the US was recognizable for the 31% increase in the value of US exports in the first five months of the year compared with the same period in 1987.

The overvaluation/trade deficit linkage had been severed. In its place, a relative rate of growth model had appeared. Furthermore, on present trends (of relative economic growth), the 1988 US current account deficit in nominal terms would show *some* improvement, which, as we have seen, would represent a drop in terms of GNP. Presto. The one-way sell-dollar bandwagon was ready to reverse direction.

And it did, with a vengeance. From the early 1988 lows, the dollar has appreciated 20% against the DM and 10% against the yen. Last week, with the \$/DM threatening to break through 190, the Bundesbank announced that it had intervened since June to the tune of no less than \$8 billion, a not inconsiderable sum, considering the dollar's "poor" fundamentals.

The fact is that the dollar was strong in the 1982-85 period, primarily because US investment opportunities looked better than those elsewhere (Europe, Japan, and/or LDCs).

In this issue

Slightly lower yields near term coming in the bond market — we're sidelined. Stock indexes are trending up for the near term, but we stay sidelined. We set our sights on a substantial recovery in copper. We remain long platinum, we liquidate our CRB/gold spread, and we're still playing wheat and cattle. Also, Friedberg Capital Markets and The Exotics. Contributions by Albert D. Friedberg, Steve H. Hanke, Daniel A. Gordon, and Michael D. Hart. This issue was prepared July 26, 1988.

The perception of a fairly disciplined monetary policy and the US government's *laissez-faire* attitude to currency intervention meant that the dollar's real appreciation would show up in a rising (nominal) exchange rate. The dollar was fairly valued, although admittedly *some* bandwagon effect had begun to develop by late 1984. Repeated intervention and/or threats of intervention kept speculators away from feasting, as they would do two years later but in the opposite direction.

The implications of this view are staggering, to say the least. From 1985 to the end of 1987, the US dollar was pushed well below its long-term real equilibrium, based on the mistaken notion that the huge trade deficit was symptomatic of an overvalued currency. Everything else being equal (is Dukakis "equal"?), the dollar should regain this long-term equilibrium — at substantially higher levels.

Of course, the US dollar could also appreciate in real terms via a relatively higher rate of inflation than its trading partners. In effect, an attempt to put a ceiling on the dollar would imply massive intervention and a tightening of monetary policy in Europe and Japan (which has already begun). This, in turn, could spell deflation in these countries and open the way for a spurt in relative US inflation. Be that as it may, the US dollar's real rate of exchange is in the midst of a dramatic recovery.

STRATEGY: Sell Swiss francs, deutschemarks, and other EMS currencies. Place stops above 56.50, basis September 1988 IMM deutschemark, close only.

Avoid selling yen and Sterling, because of their relative strength vis à vis the deutschemark (see Charts 3 to 6). We fully expect them to weaken, however.

Chart 1
US Balance of Trade/GNP

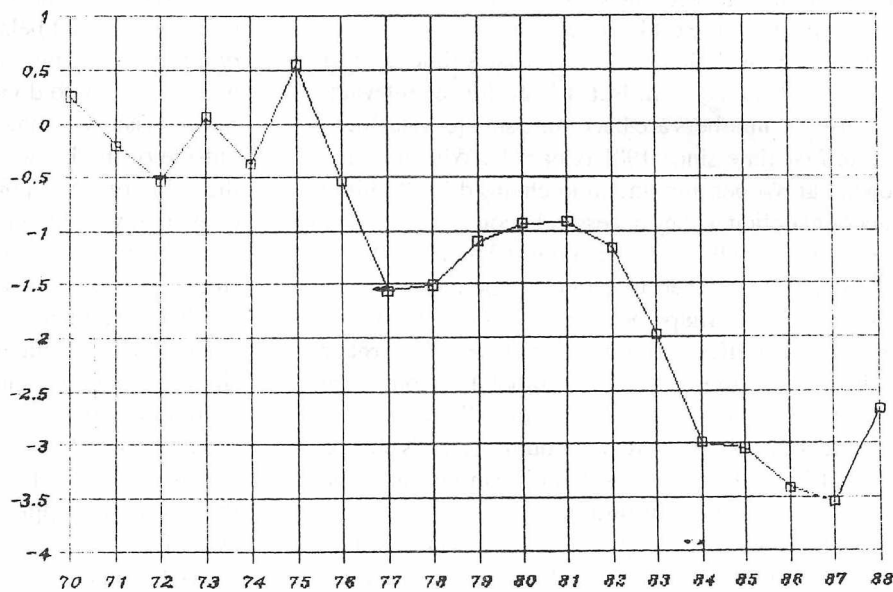


Chart 2
US Current Account/GNP



Chart 3 – CME SWISS FRANC SEP 88

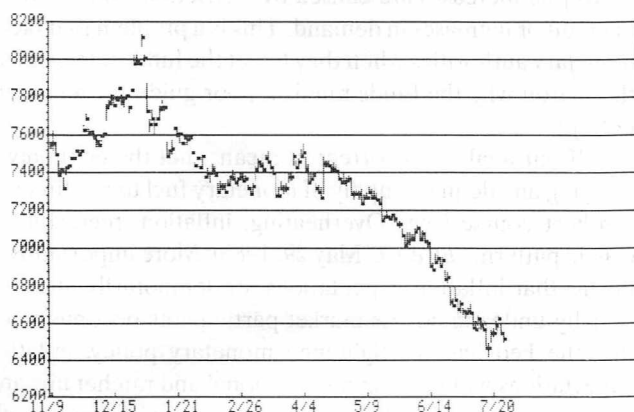


Chart 4 – CME DEUTSCHE MARK SEP 88



Chart 5

JAPANESE YEN SEP 88/DEUTSCHE MARK SEP 88

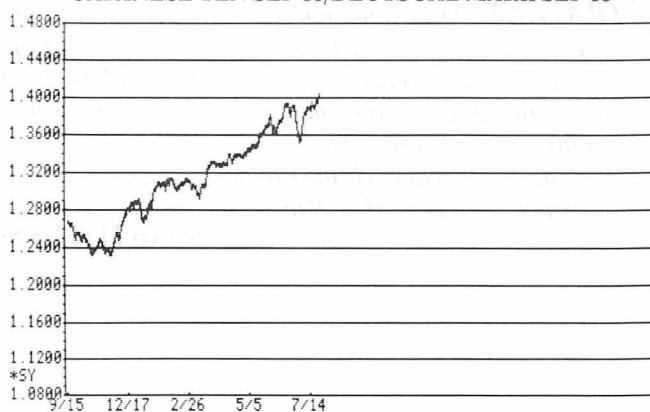
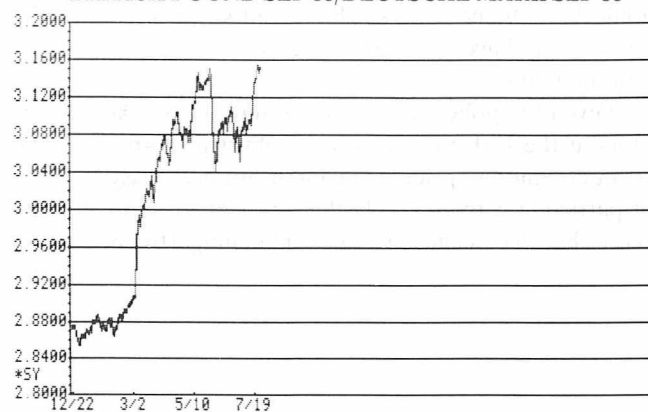


Chart 6

BRITISH POUND SEP 88/DEUTSCHE MARK SEP 88



T-BONDS

Has the Fed fooled the markets?

Since our last writing, data that confirm our views about robust economic growth in the US have been released. Specifically, 346,000 people were added to payrolls in June and the unemployment rate fell to 5.2%, which is the lowest jobless rate since May 1974. In addition, industry's capacity utilization rate was 83.1% in June, which is the highest rate in eight years.

So much for the real economy. What about monetary policy? Most observers believe that the Fed has tightened monetary policy. They base their argument on the fact that the Federal funds rate has continued to move up. Hence, they infer that the Fed has restricted the supply of credit and that inflation is under control.

We do not share this view. Rather than pro-active monetary tightening by the Fed, we believe that the increases in the funds rate have been caused, in large part, by the robust economic growth and the strong demand for credit. To support our position, we simply note that the 52-week growth rate in the monetary base remains accommodative at 7.5%

(see Chart 7). (Recall that the monetary base is a particularly good guide to Fed's intentions, because it is more directly under the Fed's control than are the various money supply measures (M1, M2, and M3).)

But some will object to our analysis by stating that if a robust economy and a strong demand for credit were responsible for the Federal funds rate increases, then the long-term rates should have risen by the same magnitude or more. But they haven't. In consequence, the yield curve has tended to become flatter. This, they argue, demonstrates that the Fed has tightened and that inflation is under control. We don't think this argument holds at present because the Fed has fooled the market participants into believing that it has, indeed, tightened. So, at least temporarily, inflation expectations are understated and long-term rates are lower than they would be if the market participants hadn't been fooled.

Now, how could the Fed fool the market participants? Before answering this question, we should emphasize that it is not the policy or intention of the Fed to fool market

participants. The Chairman of the Fed, the Vice-Chairman, and the Governors are all new "boys" on the block, and don't have much of a track record. In consequence, what they say about their intentions carries considerably more weight than if they had a long record of actions. Chairman Greenspan has given considerable testimony about the need to tighten credit as soon as the real economy heats up. Well, the real economy is heating up and is well above the performance range that had been projected by the Fed. Hence, many have concluded that Chairman Greenspan must favor tightening at this point.

Vice-Chairman Johnson, and Governors Angell and Heller have advocated, and it appears that the Fed has adopted, some sort of commodity price targeting for purposes of setting monetary policy. Although no one knows exactly what the targets are, the general idea of commodity price targeting is straightforward enough: When the commodity prices that are targeted increase, monetary policy should be tightened. Given the recent surge in commodity prices, many have concluded that the Fed governors must favor tightening.

Given the policy positions that have been taken by key actors at the Fed, the economy's robust performance, and recent commodity price behavior, it has been easy for market participants to conclude that the Federal funds rate increases have been caused by Fed tightening. (In fairness, we

should mention that it is always tricky to determine whether funds rate increases are caused by restrictions in the supply of credit or increases in demand. This is a problem that faces monetary authorities when they target the funds rate. And it's the reason why the funds rate is a poor guide for monetary policy.)

If our analysis is correct, it means that the economy is carrying an adequate supply of monetary fuel to continue on a robust course (see "Overheating, inflation, recession: A classic pattern," *FC&CC* May 29, 1988). More importantly, it means that inflation expectations are temporarily and irrationally understated. As market participants become aware that the Fed has not tightened monetary policy, inflation expectations will become more rational and ratchet upward, nominal long-rates will increase, and the yield curve will become steeper.

STRATEGY: *Over time, interest rates should rise in response to strong economic fundamentals. In the short run, however, a stronger dollar (see opening article) and the recent break in grain prices, should make for a better bond market and, thus, slightly lower yields.*

We already advised, via the Hotline, to liquidate September 84 and 86 puts at market. Remain sidelined.

— Steve H. Hanke

Chart 7
Monetary base growth rate
Log regression technique

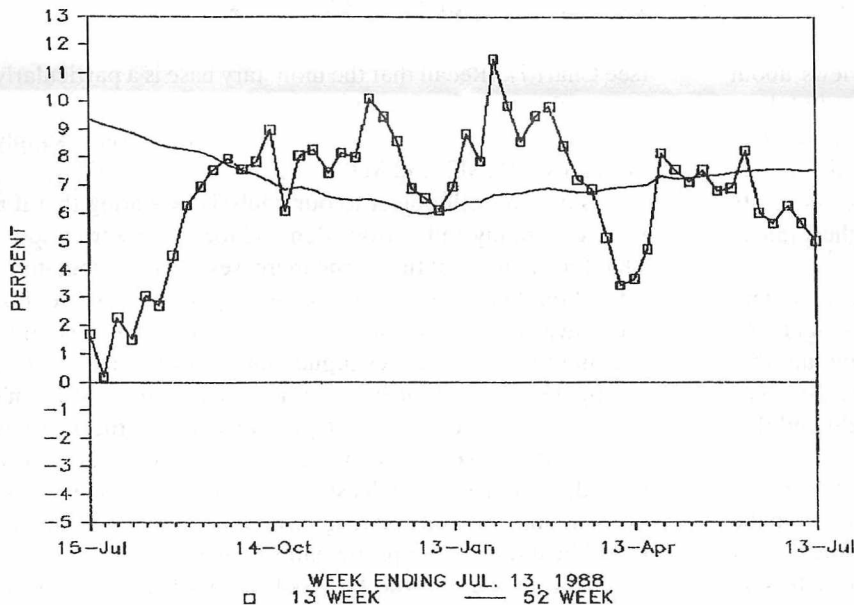
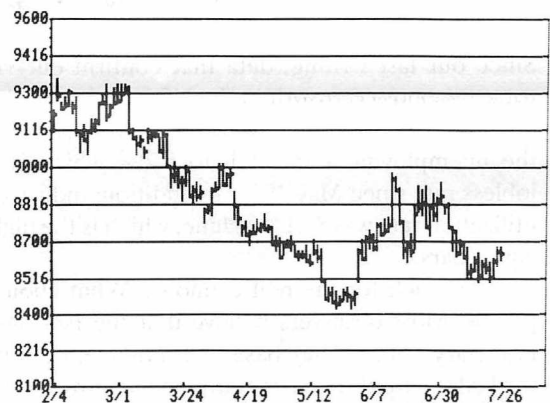


Chart 8 – CBT T-BOND (DAY) SEP 88



STOCK INDEXES

Near-term trend is up

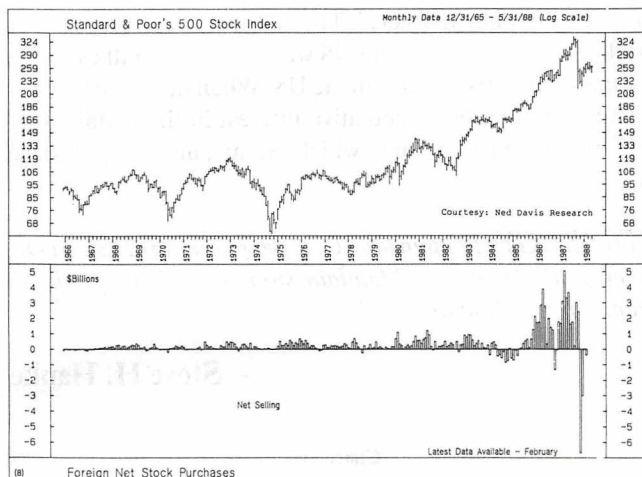
The US dollar holds the key to the near-term direction of this market for two reasons. In the first place, heavy foreign sales of US stocks (officially recorded through February 1988 and unofficially acknowledged by leading brokers to have continued to date — see Chart 9) was probably due to fears of a weaker dollar. The dollar turnaround should dispel such fears, stem the rush for the exits, and even begin a constructive reflow. Secondly, a stronger dollar should help the US bond market (see our bond comments) and help, at least temporarily, reverse the uptrend in yields. At 1.12 times bond yields to stock earning yields (basis *Barron's* 50-stock average), the slightest easing of yields could send stock prices dramatically higher.

Other positive factors arguing for a resumption of the extended bear market rally are: a) a highly oversold market, having touched -3.6 on *Trendline's* Short-Range Oscillator, a level that in the past has invariably signalled a substantial rally; b) heavy odd-lot short selling, confirming a pervasive negative sentiment (a good contrarian tool); and c) the fact that money supply figures are beginning to show more generous three, six, and 12-month readings.

STRATEGY: While we firmly believe that the major trend is still down, the near- and intermediate-term trends are turning up.

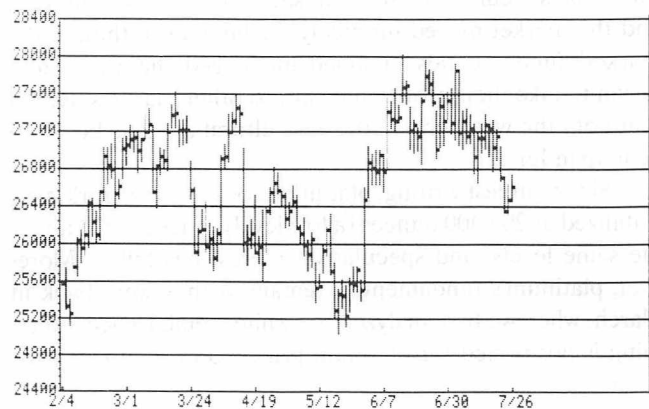
Remain sidelined.

Chart 9



Source: *The Zweig Forecast*

Chart 10 - CME 500 STOCK INDEX SEP 88



COPPER

Setting our sights on recovery

The unrelenting increase in combined LME and Comex warehouse stocks, have taken their total to the levels prevailing last November.

The most constructive thing that can be said about the market is that the warehouse build-up is a passing seasonal phenomenon; the next weeks will tell, as it appears that both New York and London evidence some tightness for mid-September deliveries. The September/December switch, at 510 points, remains unusually wide and above its most recent uptrend (see Chart 12). The July '88 position, on the other

hand, is expiring weak, while London's cash to three-month backwardation has all but disappeared.

Technically, the market is dramatically oversold, having shed 10,000 contracts or 25% of its open interest in 20 out of 21 consecutive days (on June 29, the open interest was up three contracts). Our sights are set, at a minimum, on a substantial recovery.

STRATEGY: Remain long; maintain stops at 87.00, basis September '88, close only.

Chart 11 – COMEX COPPER SEP 88

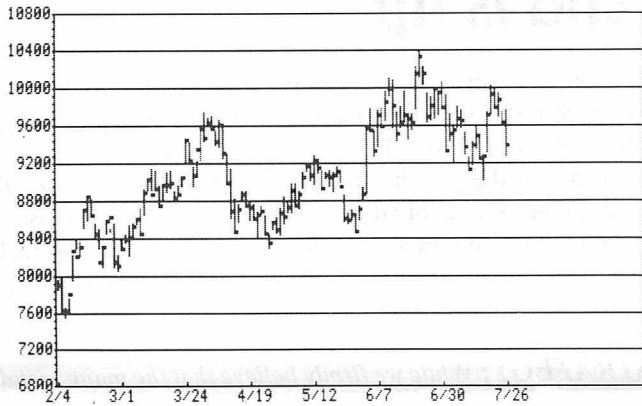
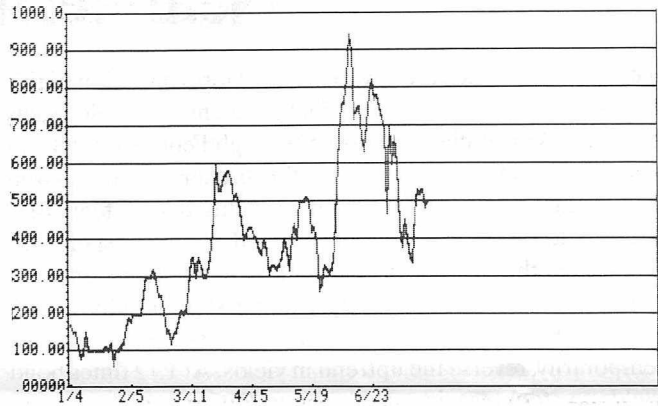


Chart 12 – COPPER SEP 88 - DEC 88



PLATINUM

Waiting for speculators, again

In April, we indicated that platinum's fundamentals were strong and that all that was needed to motivate the market was some speculators. Well, the speculators arrived in May, and the market moved up nicely. In June, even though the market's fundamentals remained unchanged, the speculators began to take their profits and shift to other markets. Recall that both the weather and the agricultural markets began to heat up in June.

Since our last writing, platinum stocks in New York have stabilized at 205,400 ounces (a low level), prices are at about the same levels, and speculative interest has fallen. Moreover, platinum's fundamentals remain as they were back in March, when we first analyzed the white metal. Hence, everything is positioned for platinum prices to move up smartly. All we need is speculators.

At this point, we see some hopeful signs. First, the metals and fabricated metal products that don't trade on futures markets have shown considerable strength, even though this period usually represents a seasonal low. A few headlines from the *Metal Bulletin* will give you an idea of what we are talking about: "Tungsten Demand Rising," "Stainless Tube Market Booms," "Producers Aim for Far East Price Hike After European Success (ferro-silicon)," "Tremendous Shortage' of Wire Rod in Europe," "Strip Products Demand Is 'Strong to Hectic,'" "Europeans Leapfrog Jo'burg Price Hike (chrome)," "Silicon Strengthens on Strong Demand," "Magnesium Maintains Strength," "ATPC Smug As Bull Run Gains Momentum (tin)," "Stractor Boosting Vanadium Output, Prices," "Elkem Blast Buys Manganese Alloys," "Ferrous Scrap Tags Leap Unexpectedly," and the list could go on. Secondly, the non-futures metal activity appears to be most vibrant in the Far East and Europe.

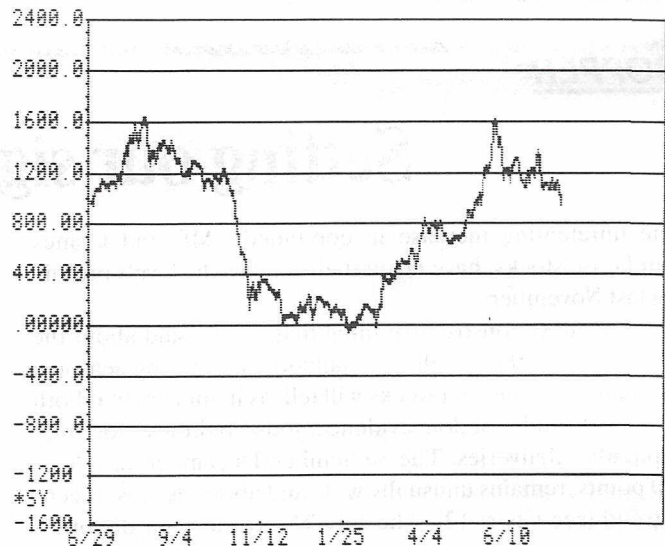
Now, you ask, "What do these two points have to do with

the US platinum market?" The action in the non-futures markets located outside the US will eventually spill over into the metals futures markets in the US. When this occurs, it will attract considerable speculative interest in the metals complex (including platinum, which is, in part, an industrial metal.)

STRATEGY: Remain long October platinum (2)/short October gold (1) spread. Maintain stops at \$70/oz. platinum premium, on close only.

– Steve H. Hanke

Chart 13
PLATINUM OCT 88 - GOLD OCT 88



CRB INDEX

CRB/gold: signs of topping out

Spectacular declines in the grain complex, caused by providential rains, pushed the CRB index down to its lowest level since late May. Yet our weekly advance/decline line reached at the end of last week a new recovery high, revealing broad underlying support.

Near term, we believe that the weakness in grain prices may be overdone; rallies from these levels are almost certain and are likely to stabilize the cash CRB index above the crucial 240 level.

On the other hand, our CRB/gold spread has begun to show signs of topping out (see Chart 14): We therefore advised liquidating the spread at market in today's Hotline. This spread, first recommended in our Feb. 21 *FC&CC*, showed a \$75,400 profit on a \$32,500 investment (2 CRB long vs. 5 gold short).

STRATEGY: Remain long September '88 CRB, placing stops at 239, basis cash index, close only.

Chart 15

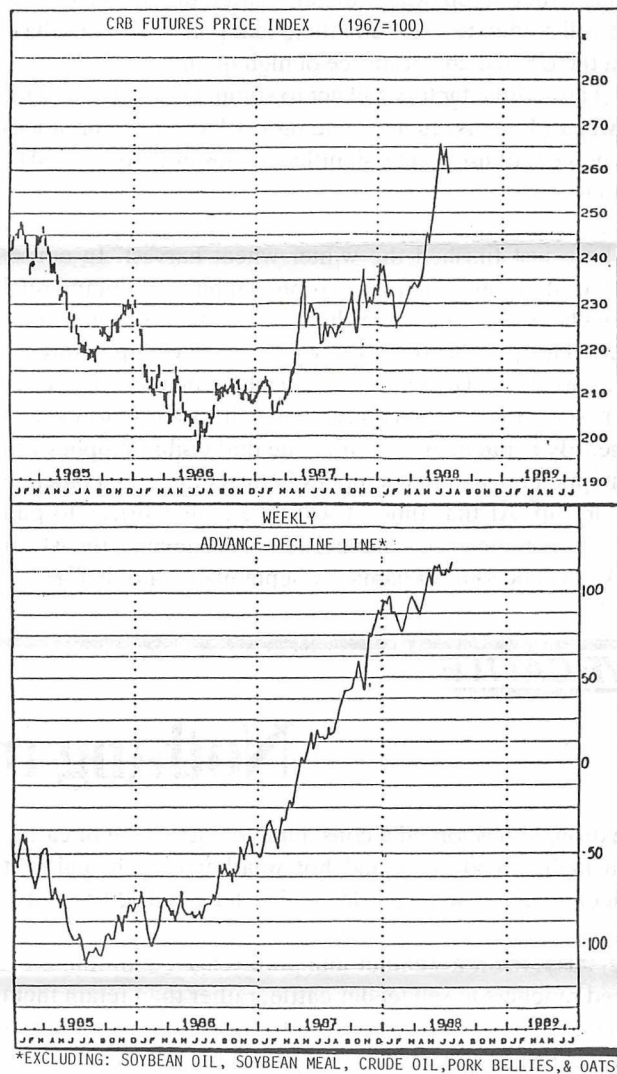
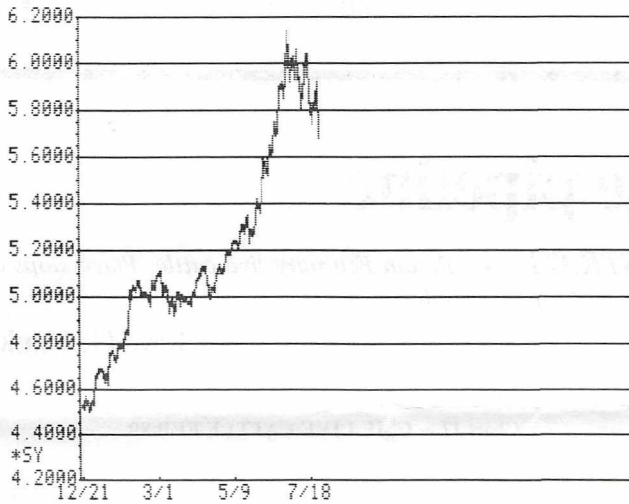


Chart 14
CRB SEP 88/GOLD AUG 88



WHEAT

Still an undervalued commodity

In last month's wheat article, we reported that the USDA estimated (as of June 9, 1988) the 1988-89 "ending stocks" at 781 million bushels and "ending stocks as a percent of use" at 30.2%. These are bullish numbers. Since then, we have scrubbed the numbers a bit, and have concluded that ending stocks will probably come in at 600 million bushels or less. This would push ending stocks as a percent of use towards 20%, which is a very low number.

Several significant factors weigh on our thinking:

- Wheat remains cheap, relative to corn. In consequence, animal feed rations have been adjusted, so that wheat can be substituted for corn. This boost in the demand for wheat has not been factored into USDA estimates and is not fully appreciated by market participants.
- The Canadian crop will come in well below USDA estimates. This has been confirmed by Canadian officials,

who have passed their views along to the USDA. The shortfall in Canada will force many buyers, who have purchased wheat from Canada in recent years, to divert some of their demand to the United States. To appreciate the magnitude of this diversion, consider that the Chinese might be forced to reduce their Canadian purchases by as much as 70%.

- Unlike the North American producing areas, the Soviet Union has been plagued with too much rain. In consequence, their crop will probably suffer quality problems. This will stimulate some unanticipated pressure to purchase from the US, which is a source of high-quality wheat.

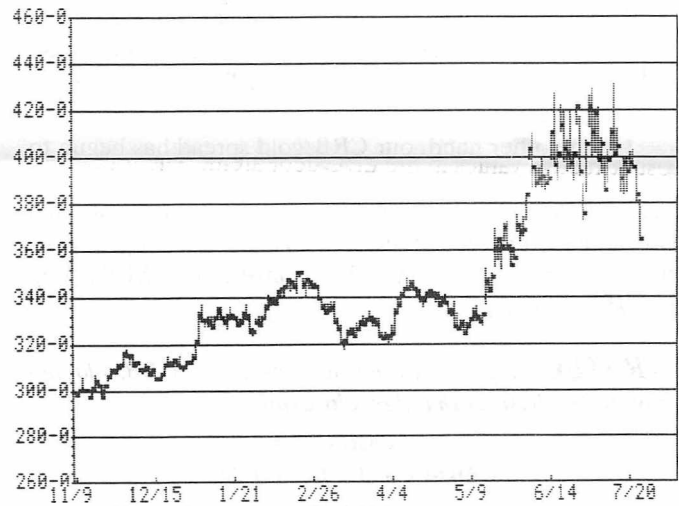
These three factors will act to stimulate the demand for US wheat. In consequence, ending stocks and ending stocks as a percent of use will be significantly lower than the USDA estimates.

Before closing, a word on market dynamics is in order. We have just finished the winter wheat harvest. In consequence, there are adequate visible supplies in commercial channels (wheat that is not held by farmers or the government). This post-harvest supply puts downward pressure on wheat prices, and explains why the wheat market has not yet taken off. However, this situation will not last too much longer. By September, we anticipate that visible supplies will be mopped up, and that supplies in the commercial pipeline will dry up. At that time, it will take higher prices to pull wheat into commercial channels. In consequence, the wheat market will become dynamic by September, if not before.

STRATEGY: Retain September calls. Add to positions by purchasing December wheat at \$3.55 on temporary dips. Place initial stops at \$3.20, on close only.

– Steve H. Hanke

Chart 16 – CBT WHEAT DEC 88



LIVE CATTLE

Nothing in the pipeline

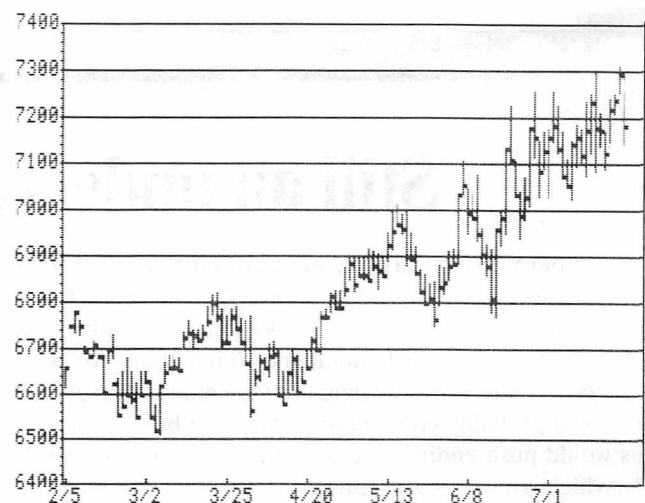
The drought has forced a considerable liquidation of cattle. With higher feed costs and hot weather (which makes it difficult to maintain fat cattle weights, let alone add pounds), feed lot operators have been selling fat cattle before their time. Also, the hot weather and poor range conditions have forced ranchers to sell feeder cattle, rather than retain them for herd rebuilding purposes. Note that cattle herds are at very low levels, and with normal weather conditions, ranchers would have refrained from selling so many heifers. In summary, the drought has been an external stock that has caused a surge of cattle through the production pipeline. If this supply surge wasn't enough, the hot weather has reduced the demand for beef products. In consequence, there is significant weakness in the cash and nearby futures markets.

However, the recent surge of cattle through the pipeline simply means that, in the coming months, the pipeline will tend to dry up because there simply won't be an "adequate" number of animals available for the markets. Moreover, it is in these future months that the weather will cool off and the demand for beef products will pick up. These supply-demand dynamics will squeeze the live cattle market severely and throw the market from contango into backwardation.

STRATEGY: Retain February live cattle. Place stops at 67.50¢, on close only.

– Steve H. Hanke

Chart 17 – CME LIVE CATTLE FEB 89



FRIEDBERG CAPITAL MARKETS

LDC debt opportunities

The well-diversified portfolio includes a measure of higher-risk/higher-return investment vehicles. For this reason, Friedberg Capital Markets is making available some very attractive US dollar-denominated investment alternatives for risk-conscious accounts.

In general, LDC debt trades quite actively in secondary markets, but the principal players are banks and large financial institutions, who trade in \$1-\$10 million amounts. Friedberg Capital Markets has selected what we consider the most attractive values in the LDC debt arena. The following are our present US dollar-denominated LDC offerings:

Banco Central de Chile

12-month (annual) Libor + 1 1/8%
 current coupon 9.0625%
 Price 65 3/4
 current yield 13.78%

Argentina Bonex Series 82 15/2/92

Libor flat (semi-annual)
 Current coupon 7%
 Amortization yearly 12.5%
 Price 80.10
 Internal rate of return 22.6%

In general the percentage of an investor's total portfolio that would be devoted to these issues is commensurate with the investor's willingness to accept a calculated strategic risk. We will continue keeping our clients informed of further opportunities in the LDC debt market as we selectively expand our list of offerings.

Chart 18
Foreign Currency Bonds

Date: July 21, 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					
TORONTO DOMINION BANK 02/04/90 18% RRSP eligible	104	- 104 3/4	14.43	02/04/88-02/04/89	
BANK OF NOVA SCOTIA 15/09/89 18 1/2% RRSP eligible	103 3/4-	104 1/2	13.79	15/09/87-15/09/88	
WELLS FARGO (semi annual) 12/05/89 16 1/8%	100 1/4-	101	15.18	12/05/88-12/11/88	
EASTMAN KODAK (semi annual) 15/02/89 17%	100 1/2-	101 1/4	15.02	15/02/88-15/08/88	
HONDA INTERNATIONAL 20/09/89 16 3/8%	100	- 101	15.21	20/09/87-20/09/88	
TOURIST HOTEL (N.Z.) 04/06/93 zero coupon	49 3/4-	51 3/4	14.55	matures	04/06/93
AUSTRALIAN DOLLAR DENOMINATED BONDS					
COMMONWEALTH BANK OF AUSTRALIA 01/07/94 14%	102 3/4-	103 1/2	13.10	01/07/88-01/07/89	
WORLD BANK 15/03/93 12 3/4% RRSP eligible	99	- 99 3/4	12.77	15/03/88-15/03/89	
CAN. IMP. BANK OF COMMERCE 13/03/91 13% RRSP eligible	97	-		13/03/88-13/03/89	
DANISH KRONE DENOMINATED BONDS					
WORLD BANK 20/11/92 9 3/4% RRSP eligible	98 1/4-	99	10.02	20/11/87-20/11/88	
STOCKHOLM 10/11/91 10 5/8%	103	- 103 3/4	9.21	10/11/87-10/11/88	
DEUTSCHE MARK DENOMINATED BONDS					
GOVT. OF BELGIUM 29/4/96 5 1/2%	95 3/4-	96 1/2	6.07	29/04/88-29/04/89	
QUEBEC HYDRO 1/5/96 5 1/2 RRSP eligible	95 3/4-	96 1/2	6.07	01/05/88-01/05/89	
SWISS FRANC DENOMINATED BONDS					
GOVT. OF AUSTRALIA 30/10/98 5%	101 1/2-	102 1/4	4.72	30/10/87-30/10/88	
JAPANESE YEN DENOMINATED BONDS					
GOVT. OF CANADA 23/7/93 5 5/8% RRSP eligible	101 7/8-	102 5/8	5.02	23/07/87-23/07/88	
U.S. DOLLAR DENOMINATED FLOATING RATE NOTES					
ISSUER MAT. DATE COUPON	BID	OFFER	CURRENT COUPON		
UNITED KINGDOM 24/9/96 3 mo. LIBID-1/8 (quarterly)	100.05-100.35		7.5%	24/06/88-24/09/88	
BANCO CENTRAL (restructured)	61 3/4-65 3/4		9.0625%	20/01/88-20/01/89	
De CHILE 12mo. LIBOR +1 1/8 (annually)					

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.

	U.S. \$	NEW ZEALAND \$	AUSTRALIAN \$	DEUTSCHEMARK	SWISS FRANC	JAPANESE YEN	DANISH KRONE
1 year	7.74%	Wells Fargo 16 $\frac{1}{8}$ 12/5/89 Yields 15.18% (.625 NZ/US)					
2 year	8.30%	Toronto Dom. Bk. 18% 2/4/90 yields 14.43% (.598 NZ/US)					
4 year	8.59%						World Bank 9 $\frac{3}{4}$ 20/11/92 yields 10.02% (7.35 DKr./US)
5 year	8.70%	Tourist Hotel 0% 4/6/93 yields 14.55% (.514 NZ/US)	World Bank 12 $\frac{3}{4}$ 19/3/93 yields 12.77% (.676 A/US)			Canada 5% 23/7/93 yields 5.02% (111.07 US/JY)	
6 year	8.80%		Com. Bk. of Aus. 14% 1/7/94 yields 13.10% (.643 A/US)				
8 year	8.97%			Hydro Quebec 5 $\frac{1}{2}$ 1/5/96 yields 6.07% (1.48 US/DM)			
10 year	9.10%				Australia 5% 30/10/98 yields 4.72% (1.01 US/SF)		
Spot Exchange Rate	N/A	.6685	.8125	1.8365	1.5275	131.95	6.9835

**For example, in parentheses, since a US\$ based investor would receive 744 basis points (518-774) by holding the Wells Fargo NZ Bond, NZ\$ can depreciate to .625 NZ/US from the present spot exchange rate of .6685

NZ/US over the next 1 year for the NZ\$ investment to break even with current US\$ rates of interest. Assumes that bonds are held to maturity, and coupons are reinvested.

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

Had you invested on June 30/87 in:	% appreciation/ depreciation due to currency fluctuation	% appreciation/ depreciation due to price of bond interest rate fluctuation X currency appreciation	Nominal Coupon X currency appreciation	Total Return in US\$ *
Wells Fargo 16 $\frac{1}{8}$ % 5/12/89 NZ\$	+13.2	+2.7	+18.3	34.2%
Quebec Hydro 5 $\frac{1}{2}$ % 1/5/96 DM	+ .2	+1.0	+5.6	6.8%
Canada 5% 23/7/93 JY	+10.0	-1.1	+6.2	15.1%
Australia 5% 30/10/98 SF	+ .3	+ .2	+5.2	5.7%
C.I.B.C. 13% 13/3/91 A\$	+9.6	- .8	+14.3	23.1%

* Assumes that all coupons were reinvested fully.

THE EXOTICS

Australian dollar

A buoyant economy, spending discipline, and some asset sales produced a highly satisfactory A\$2.28 billion surplus for the 1987-88 fiscal year ending June 30, the first of its kind in the last 35 years. This surplus compares with the initial deficit of A\$27 million projected last September and a late 1987 official revision to a surplus of A\$580 million.

Significantly, outlays of A\$77.75 billion were equivalent to 26.6% of estimated GDP and represented a cut, in real terms, of 3.3% over 1986-87. Australia's current account deficit, on the other hand, has narrowed only slightly to A\$11.50 billion from A\$13.40 billion in 1986-87, A\$14.5 in 1985-86 and A\$11.1 in 1984-85.

The dramatic rise in primary commodities, which has seen the reserve bank index increase by well over 55% since early 1986, has naturally improved the country's terms of trade, allowing its private sector to indulge in a hectic import

pace. Imports rose to around 12.25% of non-farm sales in the March quarter, up from an average ratio of below 11% in 1986-87, a ratio last matched in 1984-85, before the steep depreciation of the Australian dollar.

In short, the private sector is living on borrowed time, borrowed prices, and borrowed money. Attracted by high nominal interest rates and interesting investment opportunities related to the exploitation of natural resources, capital inflows, in total disregard for the still sizable current account deficit equal to roughly 4% of GDP, have been pushing the Australian unit to new recent highs. While the path of least resistance still seems to be upward, the present rarefied levels make us uneasy. At any rate, a recent reaction down to .7850 triggered our .7950 stop, helping us realize some substantial profits.

STRATEGY: *Remain sidelined.*

Chart 21

YEAR	US DOLLAR PER AUSTRALIAN DOLLAR (Period Average)	U.S.		BASKET	
		1967 = 1.00	1973 = 1.00	1967 = 1.00	1973 = 1.00
1967	1.1125	1.0000	1.2931	1.0000	1.2377
1968	1.1125	1.0150	1.3125	0.9561	1.1834
1969	1.1110	1.0418	1.3472	0.9799	1.2129
1970	1.1137	1.0588	1.3692	1.0016	1.2396
1971	1.1361	1.0197	1.3186	0.9947	1.2311
1972	1.1923	0.9494	1.2277	0.9576	1.1852
1973	1.4195	0.7733	1.0000	0.8080	1.0000
1974	1.4378	0.7356	0.9512	0.7702	0.9532
1975	1.3102	0.7662	0.9908	0.8129	1.0061
1976	1.2252	0.7637	0.9875	0.7740	0.9580
1977	1.1090	0.8003	1.0349	0.8309	1.0284
1978	1.1447	0.7730	0.9996	0.8451	1.0459
1979	1.1179	0.8073	1.0439	0.9191	1.1376
1980	1.1395	0.8162	1.0555	0.9641	1.1932
1981	1.1493	0.8122	1.0503	0.8940	1.1065
1982	1.0174	0.8775	1.1347	0.9166	1.1344
1983	0.9024	0.9299	1.2025	0.9230	1.1424
1984	0.8796	0.9524	1.2316	0.8946	1.1073
1985	0.7008	1.1624	1.5032	1.0839	1.3402
1986	0.6709	1.1390	1.4729	1.1431	1.4148
1987	0.7009	1.0397	1.3445	1.1122	1.3765
1988 (1Q)	0.7196	0.9898	1.2799	1.1217	1.3883

----- BASKET -----
 U.S. 29% JAPAN 44%
 U.K. 10% NEW ZEALAND 7%
 Germany 10%

Above 1.00 = undervalued
 Below 1.00 = overvalued

Chart 22

Year	Foreign Assets (Bln US\$)	CURRENT ACCOUNT As % of GNP	CUMULATIVE 12 QTR. Current Account (Bln US\$)
1970	1,817	-2.35	-3135
1971	3,330	-2.11	-2621
1972	6,079	+0.09	1250
1973	5,776	+0.06	+ 11
1974	4,137	-3.44	-1952
1975	3,653	-1.13	-3408
1976	2,571	-1.99	-5780
1977	2,952	-3.00	-6040
1978	3,411	-4.06	-9563
1979	4,016	-2.16	-10267
1980	6,573	-2.90	-11331
1981	4,474	-5.10	-15302
1982	8,912	-5.22	-21169
1983	11,487	-3.80	-22972
1984	9,573	-4.92	-22983
1985	7,012	-5.68	-23173
1986	4,953	-6.14	-27032
1987	7,963	-4.63	-27190

Chart 24

Spot	1 Month	3 Month	6 Month	12 Month
.8074-	.8042 -	.7982-	.7895 -	.7734-
.8079	.8050	.7990	.7905	.7754

Chart 23

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

Reserves * + Previous 12-months current Account *** = 7447
 (Reserves + 12-months C/A) / M1 ** = 7447/24036 = 31%
 (Reserves + 12-months C/A) / Broad Money ** = 7447/96337 = 7.7%
 *As at May 1988 ** April 1988 *** July 1987 - June 1988

 Figures in millions of U.S. Dollars

	M1 (Converted to U.S. Dollars)	Broad Money (Converted to U.S. Dollars)
1978	14 621	49270
1988(May)	24036	96337

% Increase (decrease) 64.4% 95.5%

Corresponding % increase in the United States 106.9% 108.5%

 (a) 1987 Imports as percentage of GNP 14.32%
 (b) 1978 - 1987 Imports as percentage of GNP 13.94%
 1987 / 1978 - 1987 average) = (a)/(b) = 102.7%

 Source: IFS

FOREX RATES & UPDATE

<u>Currency</u>	<u>Spot</u>	<u>3-Month</u>	<u>12-Month</u>	<u>Comments vis à vis US\$</u>	<u>Comments vis à vis DM (Spot DM: 185.60)</u>
*Belgian franc	38.89-38.92	38.80-38.85	38.32-38.45	Sell	Buy
*Danish krone	7.0640-7.0690	7.0640-7.0740	7.0650-7.0900	Sell	Remain long
*Dutch guilder	2.1000-2.1010	2.0836-2.0849	2.0364-2.0386	Sell	Remain short
Greek drachma	148.70-148.80	150.45-152.75	155.20-164.30	Remain short	Remain short
*Hong Kong dollar	7.8025-7.8035	7.8030-7.8050	7.8000-7.8175	Neutral	Buy
*Irish punt	1.4425-1.4440	Not available		Sell	Neutral
*Italian lira	1373-1374	1382-1385	1409-1414	Sell	Remain short
*Kuwaiti dinar	.28260-.28290	.28060-.28135	.27535-.27725	Sell	Neutral
Malaysian ringgit	2.6270-2.6280	2.5970-2.6010	2.5220-2.5430	Neutral	Neutral
New Zealand dollar	.6680-.6690	.6570-.6590	.6305-.6365	Neutral	Neutral
*Norwegian krone	6.7410-6.7460	6.8210-6.8300	6.9985-7.0110	Sell	Neutral
*Portugese escudo	150.00-150.50	151.50-152.50	154.75-158.00	Sell	Remain long
Saudi Arabian riyal	3.7500-3.7510	3.7545-3.7575	3.7560-3.7600	Remain short	Remain short
Singapore dollar	2.0375-2.0385	2.0320-2.0335	1.9825-1.9885	Neutral	Neutral
*Spanish pesetas	122.90-123.00	123.50-123.70	125.00-125.30	Sell	Neutral
*Swedish krona	6.3790-6.3840	6.4120-6.4190	6.4775-6.4900	Sell	Neutral

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, June 28: The market letter is in the mail. No changes or new recommendations.	Friday, July 22: No changes or new recommendations.
Friday, July 1: No changes or new recommendations.	Flash update, Monday, July 25, 2:45 p.m.: Liquidate long September 84 and 86 T-bond put options at the market.
Friday, July 8: No changes or new recommendations.	Tuesday, July 26: 1. Liquidate CRB/gold spreads at market. 2. As of yesterday's flash, we recommended liquidating long September 84 and 86 T-bond put options.
Tuesday, July 12: No changes or new recommendations.	
Friday, July 15: No changes or new recommendations.	
Tuesday, July 18: No changes or new recommendations.	

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