

FRIEDBERG'S

COMMODITY & CURRENCY COMMENTS

Friedberg Commodity Management Inc.



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The chickens are coming home to roost

After beating a retreat in March (see "On gold and the dollar: a reappraisal"), we have gained a new sense of objectivity in gold, especially with regard to the impact on prices of soaring production.

And the increases in output have been nothing less than sensational. Between 1980 and 1987, non-Communist supplies have risen by 50%. Canada's output has doubled, the US has quadrupled, and Australian production is up sixfold. While the three countries contributed together less than 100 tonnes in 1980, each one produces today in excess of 100 tonnes of gold. In the West, non-South African output has soared to 700 tonnes from less than 300 tonnes in 1980, and the expansion is set to continue well into the '90s. Overall, more than \$1 billion is now being invested annually in the search for the yellow metal, constituting more than 80% of the exploration budget of the mining companies worldwide.

The last two explosions in gold production, the Californian and Australian gold rushes around 1850 and the South African discoveries of the 1880s, tripled world output compared with the immediately preceding 50 years. The present gold rush, touching such diverse, non traditional countries as Saudi Arabia, Uruguay, Solomon Islands and Vannatu as well as the (slightly more) traditional countries like Brazil, Colombia, Chile, Venezuela, Indonesia, and so on, promises to make a mark in history not much less significant than the nineteenth century events.

Why this sudden gold rush? As night follows day, large production increases follow high real prices. From 1837 to 1849, an index of purchasing power of gold (1930=100) rose from 109.50 to 153.8; in response (and, of course, with some lag), gold production from 1849 to 1855 rose from 8.5 (an index with 1930 production equal to 100) to 30.5. Again, from 1882 to 1898, gold prices rose from 116.7 (on the same index) to 178.3; production, in turn, rose from 30.3 to 110.1 in the 12 years from 1891 to 1913. During this time, the *nominal* price of gold remained *unchanged* at \$20.67/oz. The changes in the purchasing power of gold took place via changes in the deflator — the US wholesale price index.

The combination of the 1929-33 depression and the nominal revaluation in the price of gold, to \$35/oz. from \$20.67/oz., caused the index of purchasing power of gold to rise from 90.8 in 1929 to 189.8 in 1939. Gold production, which had been languishing in the late '20s well below 100 on our index (and 15% below the rate of output achieved in 1913), soared from 95.5 in 1929 to 196.6 in 1940.

The index figures compiled and computed by R. W. Jastram in his excellent work, *The Gold Constant*, ended in 1976, at the time of the publishing of the book. To gain a perspective of where we stand today, we prepared Chart 1, depicting the average of the daily price of gold deflated using the US index of wholesale prices.

The finding is remarkable in that it shows that the average price for 1987 is still substantially higher, in real terms, than the 1934 price. In Jastram's terms, the index of purchasing power of gold stands today at approximately 475!

As we saw, index of purchasing power of gold numbers above 153.8 (1849), 178.3 (1898), and 189.8 (1939) drew gold from the "moon," in one case almost quadrupling production. Conceivably, an index of 475 threatens to unleash a massive torrent of gold onto the world's market.

What will be the effect on gold prices? In the nineteenth and early twentieth century, with gold being a "fixed" varia-

In this issue

Platinum's fundamentals remain strong, and we roll over our spreads. We're bullish on the greenback and bearish on the yen. We're in a CRB/gold spread. Oil is en route to \$5 per barrel. The stock market is dull — and dangerous, so we short. Also, wheat, soybeans, copper, cattle, and Friedberg Capital Markets. Contributions by Albert D. Friedberg, Steve H. Hanke, Daniel A. Gordon, and Michael D. Hart.

ble (in accord with the prevailing gold standard), wholesale prices rose, stimulated by the gold "inflation". Eventually real gold prices fell, reducing mining profitability. Rates of production would then decrease 20% to 30% from their peak. How much did real gold prices fall? To as little as one third of their peak level (1920 compared with 1898) but more typically, to one half of the highs.

One third of the \$696/oz. high (in 1987 dollars) equals \$232, which is only slightly above the cost of new mines being brought into production using heap leaching methods. This level, however, when spliced into Jastram's index of purchasing power of gold still leaves us with an unusually high 250. Clearly, one could make a *extremely bearish case*, one that spells an ultimate bear market low of \$90-\$100/oz.

Of course, the fallacy in the above computation lies in holding wholesale prices steady at 1987 levels. A doubling of wholesale prices, even over two or three years, would make the price adjustment much less painful. In fact, under these conditions, gold prices would not have to change a great deal from where they are today to leave them, in real terms, in two or three years' time at one third of their 1980 highs.

What can we conclude? First, gold production is likely to continue expanding spectacularly in the coming three to five years, regardless of where gold prices move in the near term. Eventually, output may reach a multiple of as much as three to four times 1980 levels. Second, gold prices, in real terms, are *still* much too high. The adjustment to more normal historical levels can be accomplished in either of two ways (or a combination thereof): a nominal drop in prices and/or a

rise in wholesale prices.

The highly successful long CRB index/short gold spread, first recommended in February 1988, contained, inadvertently, the latter conclusion: *vis à vis* wholesale prices, gold had to fall. The same can be said regarding the long platinum/short gold spread. We find ourselves reinforcing the views first expressed in March, but coming from an entirely different direction. **QED.**

STRATEGY:

1. We are reentering the long 2 December '88 CRB/short 7 December '88 gold spread, risking a close below .5400.
2. We are maintaining our long 2 January '89 platinum/short December '88 gold spread, risking \$85/oz., close only.
3. We are initiating a new spread: long 5 December '89 Comex silver/short 4 December '89 Comex gold. Silver's supply and demand picture is likely to be considerably more constructive than gold's (on the demand side, expansion of photographic use and new uses; on the supply side, no spectacular increases in production, as silver is mainly a by-product of other base metals).

A trading opportunity may be developing in gold, only for the nimblest of traders and only for those who can't shake off their bullish tears (we sympathize): A much ballyhooed break below \$400/oz. should set the stage for a good-sized rally from a deeply oversold condition. Moreover, the 50% retracement of the 1983-1987 bull move is at \$394/oz., a logical support area. If you decide to take the trade, be sure to place stops at 389, basis spot Comex, close only.

Chart 1

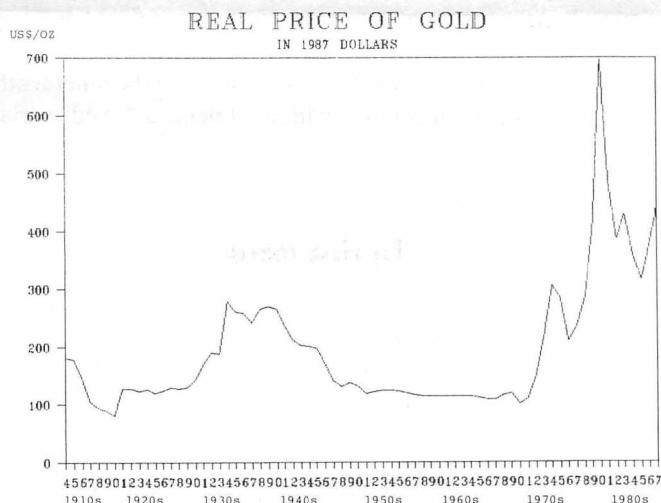


Chart 2 - CRB DEC/GOLD DEC

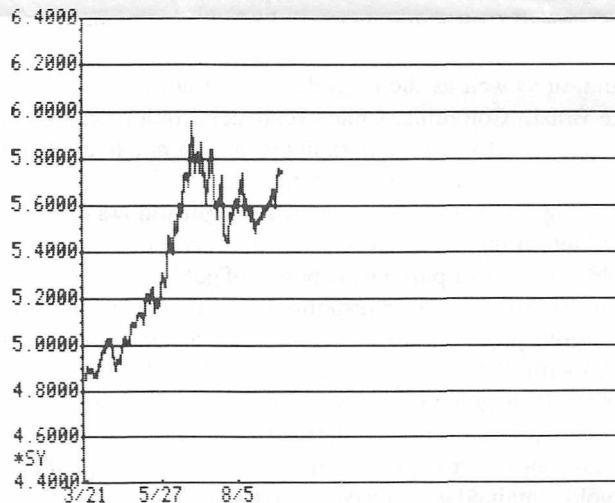


Chart 3 – PLATINUM JAN 89 - GOLD DEC 88



Chart 4 – GOLD DEC/SILVER DEC

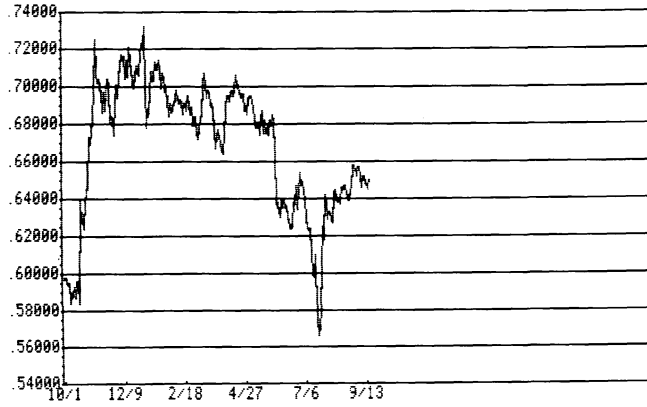
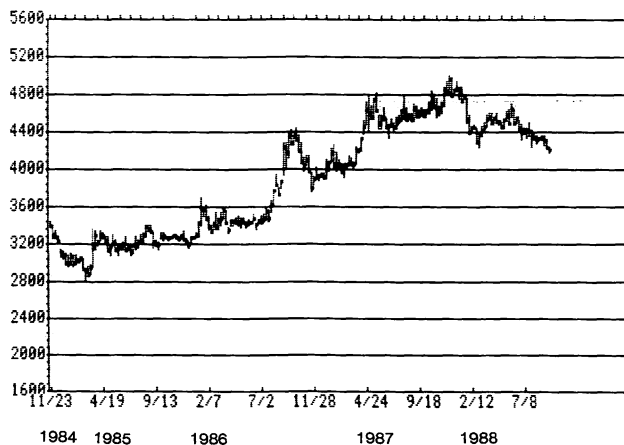


Chart 5 – COMEX GOLD



PLATINUM

The fundamentals remain strong

Since our last writing, the precious metals complex has remained under downward price pressure. However, the platinum/gold spread has held its own (see Chart 3).

Even though the precious metal bears have become a bit more aggressive as the dollar has strengthened and the economy has shown some signs of slowing (see "Supply-side spreads: a yellow light," elsewhere in this issue), we continue to favor the platinum/gold spread. Among other reasons, we should remind our readers that the end-use, commercial demand for platinum is more buoyant than other precious metals. At this time, we therefore expect platinum to show relative resilience to any further downward pressure on precious metals prices, if it should occur. Indeed, we should mention, as we did in the August issue of *FC&CC*, that the commercial metals complex remains strong, and we anticipate that this strength will eventually affect the platinum market.

The platinum fundamentals remain constructive. On the demand side, the Japanese continue to purchase platinum at record rates. Moreover, the US offtake in 1988 is up about 20% from a year earlier. Unlike 1986, when concern about developments in South Africa caused a sharp increase

in precautionary stock-building, the present increase in demand has been the result of solid economic growth, particularly in the automotive sector.

On the supply side, there has been a great deal of talk about the tough South African sanctions bill that has passed the US House of Representatives and is being debated in the Senate. However, our sources, which are most reliable about these matters, indicate that a sanctions bill will not pass the Senate. Hence, South African sanctions should not be counted on to affect platinum production one way or the other.

In addition to a more vibrant US offtake than anticipated, we note one other constructive development that has occurred since our last writing: Platinum stocks at the New York Mercantile Exchange have fallen about 11%. They are now at their lowest level since their May 1987 high.

STRATEGY: Roll over long October platinum (2)/short October gold (1) spread to long January '89 platinum (2)/short December '88 gold (1). Place stops at \$85/oz. platinum premium, on close only.

– Steve H. Hanke

THE ECONOMY

Supply-side spreads: a yellow light

During the past month, we have observed a string of data that have indicated a slowing in the economy. For example, just this past week, data showed that August retail sales declined from July by two tenths of a percent; August industrial production was up from July by two tenths of a percent, which is the smallest increase in the past five months; and the July trade deficit improved significantly from June because imports (a measure of US demand strength) fell by 8.9%.

Data reported earlier also indicates some slowing: civilian unemployment edged up in August to 5.6%, compared with 5.4% in July; the payroll survey put the number of new jobs in August at about 219,000, a drop from 283,000 in July; and the index of leading indicators declined by eight tenths of a percent in July, which is the steepest drop in eight months.

We, of course, observed these data with interest. However, the report that attracted most of our attention was the government's productivity report. This report contains both productivity and unit labor cost data. Both variables are used to compute our supply-side spreads, which are equal to changes in prices (the CPI) plus changes in productivity (output per hour) minus unit labor cost.

The financial news media reports the rates of change in productivity and unit labor costs on a quarterly basis. Economy-wide productivity declined by 0.53% from the first to the second quarter. This was the first drop in productivity (calculated on a quarter-to-quarter basis) since the fourth quarter of 1986. The economy-wide unit labor cost increased by 1.73% for the same period. The quarterly data for the manufacturing sector were not quite so discouraging, with second quarter productivity increasing by 0.9%, and unit labor cost declining by 0.15%.

To put these productivity and unit labor cost data into a more useful perspective, we use them to calculate supply-side spreads. When spreads are positive, they signal that it is profitable to increase supply, and that we can anticipate economic growth. The signal becomes stronger as the positive spread widens. Negative spreads, on the other hand, signal economic contraction. To avoid the statistical noise that is associated with quarter-to-quarter calculations, we

compute our spreads by calculating quarterly changes on a year-over-year basis. (The change for the second quarter of 1988 is computed from the second quarter of 1987 to the second quarter of 1988). These calculations for the overall economy and manufacturing are presented in Chart 6.

The spreads remain wide, particularly those for manufacturing. This indicates continued growth, and explains why the nation's operating rate for factories, utilities, and mines edged up from 83.6% in July to 83.7% in August, the highest level since February 1980. However, the spreads are narrowing, which suggests that the economy is losing some of its momentum. We, therefore, are turning on a dim yellow light for the economy. In addition, we would caution that a yellow light does not imply that a red light follows. For this to occur, we would have to observe negative spreads.

— Steve H. Hanke

Chart 4
Supply-side spreads (Rates of change)

Period	Economy-wide	Manufacturing
85 - 1	1.8%	6.9%
- 2	1.4	9.5
- 3	2.7	7.5
- 4	2.0	7.9
85 Yearly	1.8	7.9
86 - 1	4.7	7.3
- 2	3.5	3.7
- 3	2.0	3.7
- 4	3.1	3.4
86 Yearly	3.5	4.7
87 - 1	0.0	5.7
- 2	1.8	8.5
- 3	4.1	9.7
- 4	3.8	9.6
87 Yearly	2.3	8.2
88 - 1	4.8	7.9
- 2	2.1	6.5

Note: Rates of change are calculated on a year-over-year basis.

CURRENCIES

Yen's headed for a fall

Determined intervention on the part of the Bundesbank coupled with a new upward twist on German interest rates allowed central banks to check the dollar's rise in the 190 DM/\$ area. Almost coincidentally, dollar buyers ganged up on the Japanese yen, driving the dollar/yen rate to just over 137.

And for good reason. Monetary policy in Japan has

remained fairly accommodative. Despite the recent rise in short-term rates, the yield ratio (10-year Japanese government to three-month Gensaki) continues positive and above the lows seen in the first quarter.

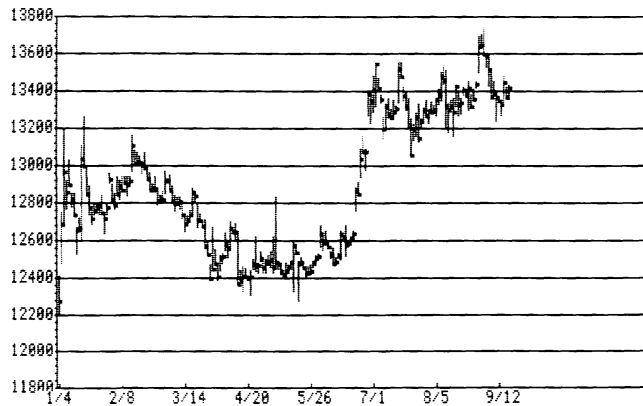
The extreme disparity between tradeables (cheap in yen terms) and non-tradeables (super-dear in yen terms) will have

to be resolved in favor of a fall in the yen exchange rate as soon as outflows on the capital account *overwhelm the current account*. Could the coming collapse in Tokyo's stock market do the trick?

STRATEGY: *We remain very bullish on the US dollar and particularly bearish on the yen. We believe that the yen will fall to a minimum of 160-165 ¥/\$ over the next six to 12 months. Risk is in the 130 ¥/\$ area, close only.*

Currency options remain relatively cheap, that is, implied volatilities are in the 9% to 12% range. We advise purchasing out-of-the-money yen puts.

Chart 7 - SPOT YEN



CRB INDEX

In and out of the CRB

No sooner had we crowed at our foresight in calling, throughout 1987, for an upside breakout of the CRB index — and a continuation of this trend (see “Up and away,” July 1988) — than the market began a retreat. Mercifully, on Aug. 2, we issued a broadcast (see Hotline Update) cautioning that “a strong intermediate or possibly longer-term top has been made in commodity prices” and advised liquidating long CRB index positions. Getting euphoric at the top, we console ourselves, is not deadly; it's just a money loser.

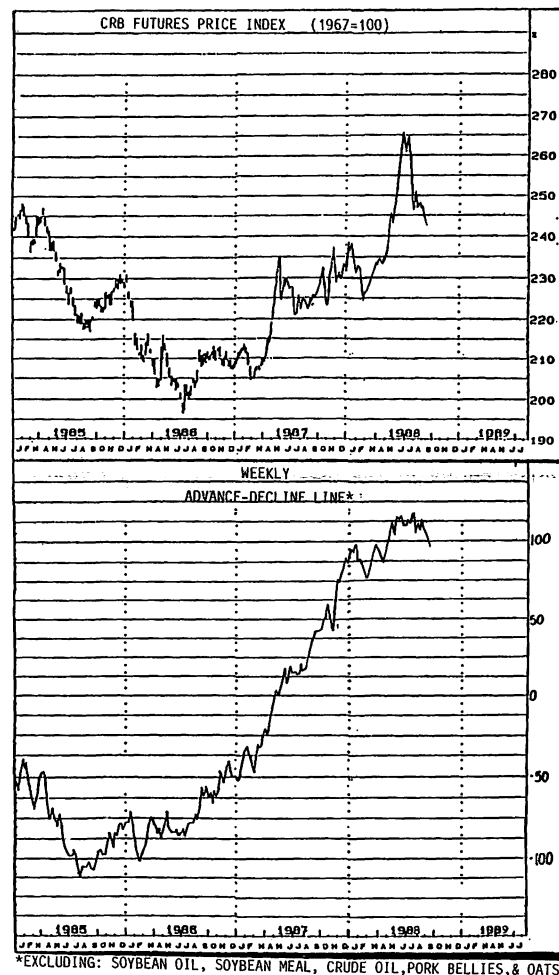
While, admittedly, our trustworthy advance-decline line has not shown nearly as much weakness as is evident from the price index (see Chart 8), the fact is that it is confirming the downtrend correction. Only a strong divergence, that is, bottoming of the A/D line while the index continues to fall, can lead us back into the long side of the market.

The downward “correction” seems to have coincided with a round of “softer” economic numbers (see “Supply side spreads: a yellow light” elsewhere in this issue). But as Professor Hanke indicates in his article, a yellow light does not a red light make, and the slowdown may turn out to be just another wiggle in the long, ascending expansion that began in 1982-83. Also, the index retreat may have been more pronounced than the breadth implies, simply because of the inordinately large weight assigned to the energy sector (about 10%).

The CRB index, however, remains an excellent leg in a CRB-component spread. Recently, we advised accepting profits on the long CRB/short gold spread (see our August 1988 issue, page 7), taking a \$75,400 profit on a \$32,500 six-month investment. In our gold discussion we advise, once again, to reinstate the spread (see “gold” for a more detailed discussion).

STRATEGY: *See page 2, Strategy 1.*

Chart 8



*EXCLUDING: SOYBEAN OIL, SOYBEAN MEAL, CRUDE OIL, PORK BELLIES, & OATS.

ENERGY FUTURES**En route to \$5 a barrel**

In our Feb. 21 issue (and again in the April 24 issue) we presented three scenarios, giving each one a 33% probability of occurring. In the first one, Opec continued to muddle through, with excess production of ± 1.5 million barrels per day (b/d), hoping for some miracle. Prices would drift lower, we said at the time, and challenge the 1986 lows. "Eventually, low prices would cause cheating, output would increase, and prices would fall to the \$5/barrel area." The termination of hostilities between Iran and Iraq has added to Opec's excess production, which now stands at somewhere between 2 million and 3 million b/d instead of the 1.5 million b/d of earlier this year. We are upping the odds for this scenario to occur, to 50% from 33%.

In the second scenario, which we are now down-grading to 0% from 33%, Opec puts it all together again by recommending pro-rata cutbacks. None of the Gulf producers have shown any willingness to abide by lower production quotas. To the contrary, Iraq, Kuwait, and the UAE have become substantial "cheaters" and are overproducing by as much as 50%.

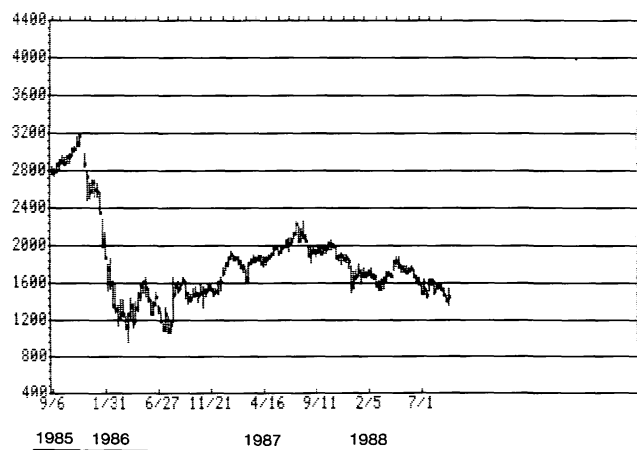
In the third scenario, Saudi Arabia and some or all of its Gulf allies pulled away from Opec and raised output to full capacity. As we said then "this strategy would spell sharply lower prices at first, and eventually some sort of equilibrium around the \$7-\$8/barrel mark." We have now upgraded this possibility to 50%.

In conclusion, prices may follow either of two paths: They may *drift* lower to reach 1986 lows (around \$9/barrel),

rally on some desperate Opec verbal exercise, and then plunge (on increased cheating — to make up for lost revenues) to \$5/barrel; or prices may collapse rapidly on deliberate Gulf-producers' overproduction, and *eventually* settle in around \$7-\$8/barrel. There is no other possibility. As we said then (and ever since time immemorial), Opec au revoir.

STRATEGY: *Maintain short positions, risking a close above 16.05, basis November.*

Chart 9 — NYME CRUDE LIGHT

**STOCK INDEXES****The bear... continued**

The inability of the stock market to react positively to a relatively strong dollar and a much improved bond market — two events we correctly anticipated in our issue of July 26 — increases the probability that the next major intermediate move is to the downside. The odds are being reinforced by the fact that we are in the midst of a long bear market.

In previous issues we have attempted to estimate the likely path of the bear. We drew two downtrends: one that assumed a "normal" bear market, in keeping with the post-war experience, and lasting two years (from August 1987, of course); the other, a lengthier phase, running three years, and ending in August 1990. *Both* downtrends were targeted to end at around 135, basis the S&P 500 (1100 Dow Jones Industrials), the *inflation adjusted "base"* of the past 70 years.

While the first phase of the bear market (approximately 337 peak to 220, basis S&P 500) naturally exceeded our

"idealized" steady decline, the past nine months have seen a dull catch-up process. At present levels, the S&P 500 trades well above the first downtrend (depicting the shorter duration bear market) but is only slightly above the second downtrend (now resting just above 262). This raises our suspicion that the present bear market will be not only devastating but also rather prolonged.

There are a number of reasons why we believe that the weak rally that began in December 1987 is about to stall.

- **Money supply.** In the first place, narrowly-defined money supply (M1), while growing slightly faster than in 1987, has not become sufficiently strong to provide "excess" liquidity. For the past eight weeks it has grown at 4.9% annualized, almost dead-on with its rate of growth for the past 12 months and well below the 17% annualized pace experienced in 1986.

- **Debt service.** The corporate debt-service burden continues to mount. According to a recent Merrill Lynch study, interest payments absorbed more than 20% of nonfinancial corporations' cash flow in the second quarter, as in 1974 and 1982, despite that fact that unlike the recession years of 1974 and 1982, the economy had been booming. The implications are horrifying: The next recession will take an immense toll.

- **Sluggish A/D line.** Technically, the advance-decline line remains extremely sluggish and well below the March and June high. There is practically a nil plurality of net new highs despite a 10-month advance.

- **Bearish sentiment.** Ex-dividend capture volume has continued to shrink, and sentiment shows more bears than bulls, but not excessively so, avoiding readings of extreme pessimism.

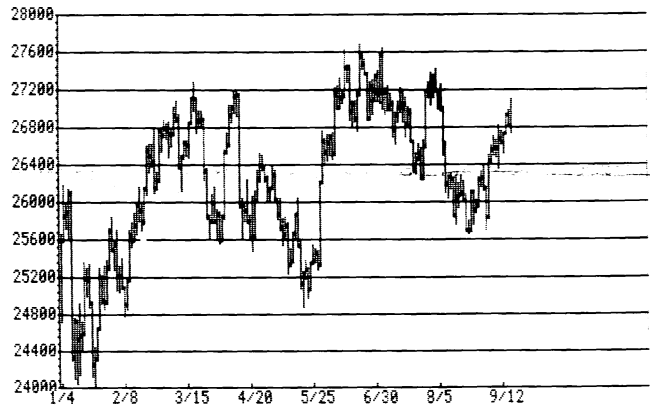
- **Oversold no more.** The extreme oversold condition of late July and mid-August (which prompted us to recommend purchase of call options for short-term traders) has been cleaned up, although we are still short of overbought readings.

A look at Chart 10 makes it clear that the market will have to clear some heavy overhead at 270-276. A failure to do so in rather short order will break the laborious rising lows/rising highs uptrend, which began soon after the crash, and will move the market below its own 30-week moving average, continuing a resumption of the major downtrend.

STRATEGY: Dullness has fostered a large enough degree of complacency to create the perfect background for another substantial downleg. It has also lulled option writers into a dangerous sense of security (making option premiums cheaper than they have been in some time).

Two recommendations: 1) Sell December '88 S&P 500 at market, risking a close above 280, basis the cash index; 2) Purchase December '88 270 put options or March '89 270 put options.

Chart 10 - CME S&P 500 INDEX



WHEAT

Following the script

Since our last issue, the wheat market has followed our script with a great degree of exactness.

We had anticipated that the USDA would, in September, estimate the June 1989 ending stocks for the US at 600 million bushels or below, and that the critical ending stocks as a percent of use would fall to about 20%. Well, the estimate for ending stocks came in at 577 million bushels, and ending stocks as a percent of use is estimated to be slightly over 20%. The last time such a low percentage was recorded was in the 1973-74 crop year, when the percentage was 17.3%. Needless to say, these conditions caused the market to soar then, and we anticipate the same type of bullish response this time around.

As anticipated, the Canadian crop and stocks have suffered a significant decline. Canada's main wheat crop (spring wheat, which is seeded in the spring and harvested in the fall) will decline 41% from last year. This harvest will come when (as of July 31, 1988) the Canadian wheat stocks have fallen to a 36-year low (270 million bushels), which is a 42% reduction from July of last year.

The Soviets are also following our script. On Sept. 12, 1988, the USDA announced that it expected the Soviet grain harvest to be lower than that which the USDA had estimated in August 1988. The Soviets have confirmed this during the past month by making some unusually large wheat purchases

from the Common Market.

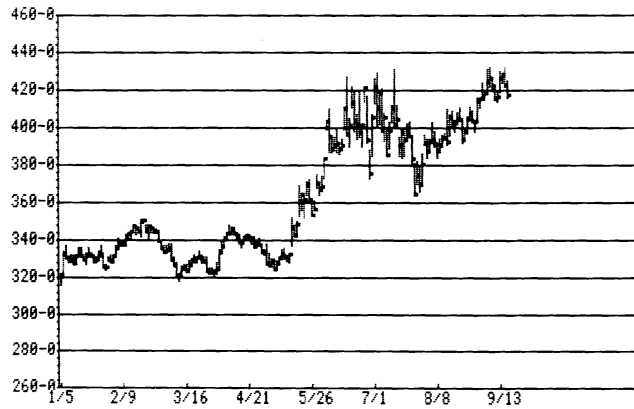
Before closing, allow us to reflect on the so-called drought aid package that has recently been passed by the Congress. This represents a new element in our script, and it will influence the markets. We indicated that with the harvest of winter wheat and high prices, visible supplies would increase and put some downward pressure on prices. Well, this did occur. However, the pressure was somewhat less than we anticipated and also shorter in duration.

Part of the reason has to do with drought aid. For obvious reasons, the checks for drought aid will most likely arrive before the November elections. In consequence, farmers anticipate that their cash flows will improve in the near future. Hence, they will be less inclined to part with as much of their wheat as they would have without drought aid. Instead, they will tend to speculate on the prospect of receiving higher prices in the future. This has reduced present marketing levels from where they might have been, and it will mean that higher prices will be required to pull wheat out of storage and into commercial channels in the future.

STRATEGY: We are long December 3.90 calls at under 33¢/bu. as per Hotline flash update Aug. 18 - see Hotline Update.

- Steve H. Hanke

Chart 11 - CBT WHEAT DEC 88



SOYBEAN/SOYMEAL

Bullish on beans

We are bullish on deferred 1989 positions. First, the \$1.15/bu. backwardation between November '88 and November '89 beans is ample enough to cover the potential contingency of much increased acreage next year.

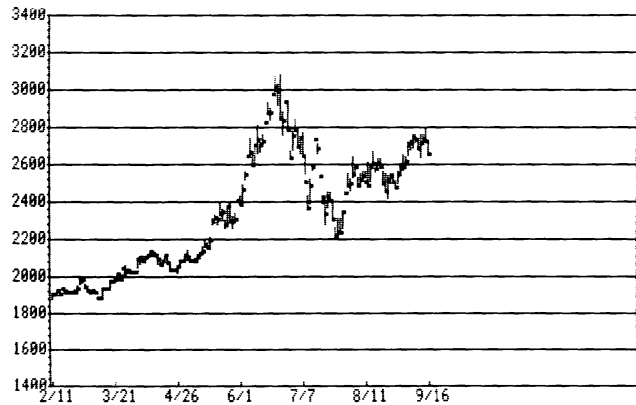
Second, the 100 million bushel carryover projected for the end of the 1988-89 crop year is much too small not to induce speculative stock-buying already in late 1988 and early 1989.

Third, dry conditions in South America could light a fire underneath this precariously-balanced market.

Fourth, any bets on next year being another drought year?

STRATEGY: Remain long November '89 beans and March '89 soymeal; place stops at 6.60/bu. and 219/ton respectively, close only.

Chart 12 - CBT BEAN MEAL MAR 89



COPPER

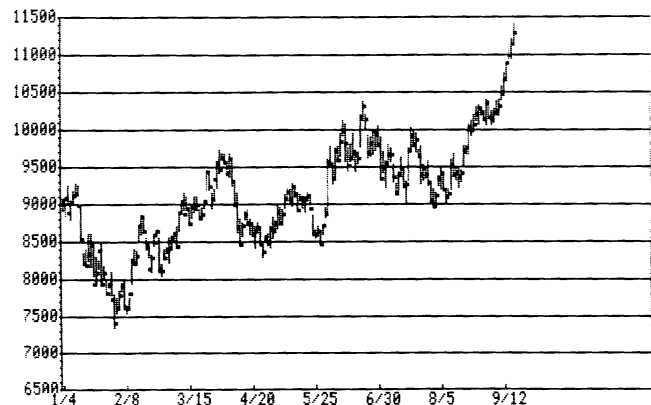
Copper rallies and we exit

Our long-awaited and hoped-for rally came ("technically," we said last month, "the market is dramatically oversold... Our sights are set, at a *minimum*, on a substantial recovery"). Prices recovered more than 20 cents/lb., basis nearby September '88.

On September 6, we advised liquidating long positions, taking advantage of the rally, and anticipating a weaker commodity scenario (see CRB).

STRATEGY: Stand aside.

Chart 13 - COMEX COPPER SEP 88



CATTLE

Cattle are bullish

The seven-state cattle on feed report as of September 1, which we reproduce below, is unequivocally bullish.

Cattle/calves data (1,000 HEAD)

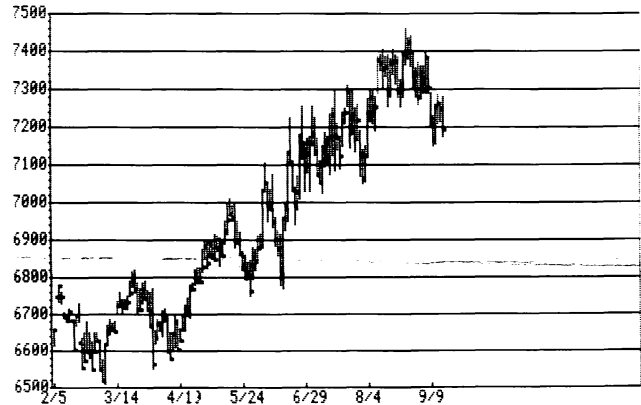
	PCT-X	1988	1987
On feed Sept. 1	98	6,674	6,818
During Aug:			
—Placed on feed	84	1,618	1,915
—Marketed	100	1,720	1,722
—Other			
Disappearance-Y	94	64	68
On feed Aug. 1	102	6,840	6,693

X:1988 as Oct. of 87.

Y-includes death losses and feedlot

STRATEGY: Raise protective stops to 70.00, basis February '89, close only.

Chart 14 - CME LIVE CATTLE FEB 89



FRIEDBERG CAPITAL MARKETS

Floating rate notes

As discussed several months ago in this column, we recommend floating-rate as opposed to fixed-rate US dollar bonds. The reason: Rising interest rates would be most beneficial to a floating-rate bondholder but would be detrimental to the holder of fixed-rate instruments. And in an environment where interest rates are rising, the Floating Rate Note's (FRN) principal is relatively unaffected, while the principal of a fixed-rate note is affected adversely.

Occasionally an opportunity arises to arbitrage two similar instruments in a manner that permits bondholders to make a windfall gain on their investment. Consider the following issues:

United Kingdom FRN quarterly (AAA) LIBID minus 1/8 current coupon 7.5% price: 100.08	Republic of Italy FRN quarterly (AAA) LIMEAN flat current coupon 8.3125% price: 99.41
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For all intents and purposes, the issuer risk is factored out, because both issues are triple A. The divergence results when reference rate and price are examined closely.

First, the reference rate of the United Kingdom bond is LIBID minus 1/8, which is approximately 25 basis points below the Republic of Italy bond's reference rate of LIMEAN flat.

Second, under the assumptions that price and reference differential were to remain the same, a swap from the United Kingdom bond to the Italy bond represents a net 92 point windfall — a recommended switch.

Chart 15

FOREIGN CURRENCY BONDS

Date: September 14, 1988
We offer the following Bonds subject to change without prior notice: Minimum amount US\$5,000 (Can.\$7,000)

ISSUER/MTY. DATE/COUPON	BID	OFFER	CURRENT ANH. YIELD TO MTY	LAST PAY DATE	NEXT PAY DATE
NEW ZEALAND DOLLAR DENOMINATED BONDS					
TORONTO DOMINION BANK	104	- 104	3/4	14.11	02/04/88-02/04/89
02/04/90 18% RISP eligible	103 1/2	- 104	1/4	13.67	15/09/88-15/09/89
BANK OF NOVA SCOTIA	99	7/8-100	7/8	15.08	12/05/88-12/11/88
15/09/89 18 1/2% RISP eligible	99	7/8-100	7/8	15.08	12/05/88-12/11/88
WELLS FARGO (semi annual)	99	7/8-100	7/8	15.07	15/08/88-15/02/89
12/05/89 16 1/8%	99	7/8-100	7/8	15.07	15/08/88-15/02/89
15/02/89 17%	99	7/8-100	7/8	15.07	15/08/88-15/02/89
EASTMAN KODAK (semi annual)	100	1/8-101	1/8	15.07	20/09/87-20/09/88
20/09/89 16 3/8%	100	1/8-101	1/8	15.07	20/09/87-20/09/88
HONDA INTERNATIONAL	50	1/8- 52	5/8	14.63	matures 04/06/93
20/09/89 16 3/8%	50	1/8- 52	5/8	14.63	matures 04/06/93
TOURIST HOTEL (N.Z.)	50	1/8- 52	5/8	14.63	matures 04/06/93
04/06/93 zero coupon					
AUSTRALIAN DOLLAR DENOMINATED BONDS					
COMMONWEALTH BANK OF AUSTRALIA	102	17/8-102	7/8	13.22	01/07/88-01/07/89
01/07/94 14%	102	17/8-102	7/8	13.22	01/07/88-01/07/89
WORLD BANK	97	7/8- 98	5/8	13.11	15/03/88-15/03/89
15/03/93 12 3/4% RISP eligible	97	7/8- 98	5/8	13.11	15/03/88-15/03/89
CAN. IMP. BANK OF COMMERCE	97	-			13/03/88-13/03/89
13/03/91 13% RISP eligible	97	-			13/03/88-13/03/89
DANISH KRONER DENOMINATED BONDS					
WORLD BANK	98	3/4- 99	1/2	9.88	20/11/87-20/11/88
20/11/92 9 3/4% RISP eligible	98	3/4- 99	1/2	9.88	20/11/87-20/11/88
STOCKHOLM	103	1/4-104		9.08	10/11/87-10/11/88
10/11/91 10 5/8%	103	1/4-104		9.08	10/11/87-10/11/88
DEUTSCHE MARK DENOMINATED BONDS					
QUEBEC HYDRO	95	- 95	3/4	7.05	01/05/88-01/05/89
1/5/96 5 1/2% RISP eligible	95	- 95	3/4	7.05	01/05/88-01/05/89
SWISS FRANC DENOMINATED BONDS					
GOVT. OF AUSTRALIA	101	1/4-102		4.74	30/10/87-30/10/88
30/10/98 5%	101	1/4-102		4.74	30/10/87-30/10/88
JAPANESE YEN DENOMINATED BONDS					
GOVT. OF CANADA	101	7/8-102	5/8	5.00	23/07/88-23/07/89
23/7/93 5 5/8% RISP eligible	101	7/8-102	5/8	5.00	23/07/88-23/07/89
U.S. DOLLAR DENOMINATED FLOATING RATE NOTES					
ISSUER	MTY. DATE	COUPON	BID	OFFER	CUR. COUP.
UNITED KINGDOM	24/9/96	3 mo. LIBID-1/8	100.08	- 100.28	7 3/4%
(quarterly)					
REPUBLIC OF ITALY	30/4/93	3 mo. Limean	99.06	- 99.41	8.3125%
(quarterly)					
L.D.C. DPAPEL DENOMINATED IN U.S. DOLLARS					
ISSUER	MTY. DATE/COUPON	BID	OFFER	CUR. COUP.	* Int. Rate of Return
BANCO CENTRAL	(restructured)				20/01/88-20/01/89
De CHILE	12mo. LIBOR +1 1/8	60	3/4 -64	3/4	9.0625 * 14%
(annually)					
ARGENTINA	15/2/92				15/08/88-15/02/89
BONEX ser.82	LIBOR (sem.ann.)	.7920	- .8070	8	9/16 ** 24.3%
					amortized: 12% of principal paid yearly

For further information and current prices please call:
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E/HICHCN

Chart 16
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	7.96%	Honda 16% 20/9/89 Yields 15.07% (.576 NZ/US)					
2 year	8.39%	Toronto Dom. Bk. 18% 2/4/90 yields 14.11% (.554 NZ/US)					
4 year	8.59%						World Bank 9% 20/11/92 yields 9.88% (7.54 DKr./US)
5 year	8.65%	Tourist Hotel 0% 4/6/93 yields 14.63% (.476 NZ/US)					
6 year	8.69%		Com. Bk. of Aus. 14% 1/7/94 yields 13.22% (.625 A\$/US)			Canada 5% 23/7/93 yields 5% (112.93 US/JY)	
8 year	8.83%			Hydro Quebec 5½ 1/5/96 yields 7.05% (1.643 US/DM)			
10 year	8.92%				Australia 5% 30/10/98 yields 4.74% (1.07 US/SF)		
Spot Exchange Rate	N/A	.6135	.7982	1.8747	1.5815	133.96	7.195

**For example, in parentheses, since a US\$ based investor would receive 711 basis points (1505-796) by holding the Honda NZ\$ bond the NZ\$ can depreciate to .576 NZ/US from the present spot exchange rate of .6135

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.

THE EXOTICS

The Saudi Arabian riyal

For several years, we have argued that Saudi Arabia will have to adjust to the fact that it has faced, and will continue to face, a deterioration in its terms of trade. Specifically, we have argued that the Kingdom must tighten its belt. If it fails to do so, the Kingdom will totally deplete its financial reserves and be forced to issue debt in the credit markets.

Let's go through the simple analytics of the situation facing the Saudis:

1. The government derives its revenue from oil exports and domestic taxes, with oil exports being denominated in US dollars and taxes being denominated in riyals.
2. The bulk of the government's expenditures include domestic wages, domestic transfer payments, and the importation of foreign goods.
3. The government is running a fiscal deficit.
4. The Kingdom is running trade and current account deficits.
5. The economy is operating at roughly full employment.

Let's assume that the Saudi currency is the US dollar. In this case, the Kingdom could tighten its belt by increasing taxes and/or reducing government expenditures. In the tax increase scenario, private consumption and investment (hence, imports) would be reduced and government revenues would

increase. In the public spending reduction scenario, domestic wages and domestic transfers (hence, imports) would be reduced. Also, government imports would be reduced directly.

Now, let's switch to the real case in which the Saudis' currency is the riyal. The Kingdom could, of course, tighten its belt in the same way as in the hypothetical case, when the currency was the US dollar: It could increase taxes and/or reduce government spending. However, let's assume that these options are politically unattractive. In this case, the Kingdom could devalue the riyal. In consequence, the government's revenue would be the same in real terms. However, its nominal revenue in riyals would increase because the riyals received per barrel of oil exported and sold in dollars would increase. Hence, in this sense, the devaluation would act like a tax increase in the hypothetical case in which the Saudis' currency was the US dollar.

Moreover, a devaluation would also act like a tax increase in another sense of the hypothetical case: If the nominal value of domestic wages paid by the government and domestic transfer payments remained the same, then the private sector's purchasing power for imports would be reduced. Thus, the devaluation of the riyal acts just as the tax increase did in the hypothetical case in which the Kingdom's

currency was assumed to be the US dollar.

So much for the simple analytics. Let's jump into the real world. The Kingdom has reduced government expenditures and increased some taxes. Moreover, it has devalued the riyal. However, given the Saudis' oil revenues, they still haven't tightened their belts far enough. They are running fiscal and current account deficits, and they are dipping into financial services.

Now, they could increase their oil output, which would, as we have pointed out before (see *FC&CC* Dec. 15, 1985), increase their government revenues. This would alleviate some of the need to engage in severe belt tightening. However, it appears that for the time being, the Kingdom will retain the *status quo* for oil production. With this oil production strategy, more belt tightening is required.

We don't feel that the political climate will allow for either tax increases or spending reductions. Given this climate, a more indirect route, such as a devaluation, is required. This occurred from 1982 through the third quarter of 1986. It is interesting to note that the devaluations, particularly the largest ones, occurred when Saudi domestic prices and the money supply (M1) were falling.

In fact, from 1982 through the third quarter of 1986, the devaluation was about 8.6%, and the domestic deflation was about 8.7%. In consequence, the devaluations reduced the purchasing power for imports at almost exactly the same rate

as the purchasing power for domestic goods was increasing. Under conditions of a deflation, residents perceive only a reduction in their power to purchase imports. What they fail to realize is the fact that their domestic purchasing power does not increase by as much as it would have without a devaluation. Hence, a devaluation that occurs during a deflation is not perceived to be as costly as one that occurs during an inflation.

From a domestic price level point of view, therefore, the climate for devaluation is not quite as favorable now as it was. The money supply (M1) has begun to grow, and prices, even though they are still about 8% lower than they were in 1982, are beginning to show some slight signs of inflation. Hence, a devaluation now won't slow a deflation; rather, it will accelerate a low inflation rate.

The bottom line of a devaluation will be the same, however. It will act as an effective belt-tightening mechanism for the Saudis, and one that will bring with it less political pain than either an overt tax increase or a reduction in public spending. It will also have the additional benefit of reducing foreigners' investment (foreign exchange) costs for petrochemical joint ventures in Saudi Arabia, a factor that the Kingdom might consider as it promotes these investments.

STRATEGY: Retain short positions in the Saudi riyal.

— Steve H. Hanke

FOREX RATES & UPDATE

Currency	Spot	3-Month	12-Month	Comments vis à vis US\$	Comments vis à vis DM (Spot DM: 1.8700)
Australian dollar	.7955-.7965	.7850-.7885	.7570-.7625	Neutral	Neutral
Belgian franc	39.30-39.33	39.19-39.26	38.78-38.96	Remain short	Remain long
Danish krone	7.2000-7.2050	7.1950-7.2050	7.1950-7.2100	Remain short	Remain long
*Dutch guilder	2.1155-2.1165	2.1010-2.1025	2.0545-2.0570	Remain short	Cover
Greek drachma	151.90-152.00	156.70-159.30	162.90-171.00	Remain short	Remain short
Hong Kong dollar	7.8090-7.8100	7.8060-7.8090	7.8060-7.8170	Neutral	Remain long
Irish punt	1.4310-1.4325	1.4345-1.4370	1.4380-1.4425	Remain short	Neutral
Italian lira	1398-1399	1406-1409	1430-1441	Remain short	Remain short
Kuwaiti dinar	.28680-.28700	.28470-.28530	.27900-.28100	Remain short	Neutral
Malaysian ringgit	2.6610-2.6620	2.6300-2.6350	2.5450-2.5550	Neutral	Neutral
New Zealand dollar	.6090-.6100	.6000-.6020	.5760-.5820	Neutral	Neutral
Norwegian krone	6.9150-6.9200	7.0000-7.0100	7.2150-7.2375	Remain short	Neutral
Portugese escudo	154.60-155.00	155.85-157.25	160.60-164.00	Remain short	Remain long
Saudi Arabian riyal	3.7500-3.7505	3.7500-2.7515	3.7535-3.7570	Remain short	Remain short
Singapore dollar	2.0425-2.0435	2.0283-2.0308	1.9915-1.9965	Neutral	Neutral
Spanish pesetas	125.05-125.15	125.75-125.95	127.35-127.90	Remain short	Neutral
Swedish krona	6.4800-6.4850	6.5100-6.5190	6.5725-6.5900	Remain short	Neutral

Explanatory Notes

*Indicates change in recommendation from last issue.

Currency expected to firm against both currencies.

Currency expected to strengthen against US\$ and weaken against DM.

Currency expected to weaken against both major currencies.

Currency expected to weaken against US\$, but strengthen against DM.

Term used to liquidate short position but does not imply a new buy recommendation.

Term used to indicate sale advice of previous long position, but does not imply a new short sale recommendation.

Buy	Buy
Buy	Sell
Sell	Sell
Sell	Buy

Cover

Liquidate

HOTLINE UPDATE

Flash Update, Friday, July 29: Liquidate long platinum/short gold spreads at market.

Friday, July 29: Several new recommendations this week.

1. As of our flash update of Monday, we liquidated long September 84 and 86 T-bond put options.
2. As of Tuesday's update, we liquidated CRB/gold spreads.
3. As of this morning's flash update, we liquidated long platinum/short gold spreads.

Tuesday, August 2: The impressive strength of the US dollar leads us to believe that a strong intermediate or possibly longer-term top has been made in commodity prices. We therefore advise liquidating outright long CRB futures positions at the market.

Flash Update, Friday, August 5, 9:45 a.m.: Buy September S&P 500 strike call options at \$4.50 O.B.

Friday, August 5:

1. As of Tuesday's recording, we have liquidated long CRB positions.
2. We have purchased S&P 500 280 call options at approximately \$4.00.

Tuesday, August 9: No changes or new recommendations.

Flash Update, Friday, August 12, 9:30 a.m.: Liquidate September 280 S&P 500 call options at \$1 O.B.

Friday, August 12: One change as of this morning's flash update (above).

Flash Update, Tuesday, August 16, 10:10 a.m.: Reinstate platinum/gold spreads by buying 2 platinum contracts and selling 1 gold contract. Place stops at 80 platinum over gold, basis the October contract.

Tuesday, August 16: We had a flash update this morning to reinstate platinum/gold spreads by buying 2 platinum and selling 1 gold, placing stops at \$80 platinum over gold, basis the October contract. One new suggestion: Sell September Canadian dollar at market, risking a close above 82.

Flash Update, Thursday, August 18, 10:30 a.m.: Buy December 390 wheat call options at 33 points or better.

Friday, August 19: A review of taped messages since July 26, our last newsletter. We are only reviewing positions that are presently open.

1. As of July 29 you, liquidated platinum/gold spreads. As of August 16, you reinstated spreads with an 80 stop, basis the October contract, platinum over gold.
2. As of August 2, you liquidated long CRB positions.
3. As of Thursday, August 16, we sold September Canadian dollar, risking 82 cents on close.
4. As of August 18, we bought December 390 wheat call options at 33 cents or better.

Tuesday, August 23: There are no changes or new recommendations. This is only a review of our previous update. As of August 18, you are long December 390 wheat call options at 33 or better.

Flash Update, Wednesday, August 24, 9:45 a.m.: Option traders who liquidated September 280 S&P 500 call options as per our advice of August 12 can now buy September 270 call options at approximately the same levels. Buy September 270 S&P 500 call options at 1.20 or better.

Flash Update, Thursday, August 25, 2:45 p.m.: Sell November crude oil, risking 16.05, close only.

Friday, August 26: There were just two recommendations this week.

1. A flash update: As of 9:45 a.m. August 24, you bought September 270 S&P 500 call options at approximately 120.
2. A flash update: As of 2:45 p.m. August 25, you sold November crude oil, placing stops at 1605, close only.

Tuesday, August 30: No changes. One reminder. As of August 25, we urged you to sell November crude oil at market, risking 1605 close only. See our recommendations, August 25, repeat.

Flash Update, Wednesday, August 31, 10:00 a.m.: As you know, we have been bullish on the US dollar, having recommended the sale of DM, SF, and other EMS currencies. However, we have purposely avoided to date the sale of JY. We are now changing direction regarding the yen and believe that the yen will show the largest depreciation of any of the major currencies. Therefore, sell December yen at market, placing initial stops at 77.00, close only.

Friday, September 2: As per our flash update of Wednesday, August 31, we have established short positions in December Japanese yen with stops at 77.00, close only.

Flash Update, Tuesday, September 6, 10:15 a.m.: Two recommendations:

1. Liquidate all long copper positions at market.
2. Buy November '89 soybeans, placing stops at 660, close only.

Flash Update, Friday, September 9, 10:00 a.m.: Accept profits and cover short Canadian dollars.

Friday, September 9: As of Tuesday's flash update, we have:

1. Liquidated long copper positions at market.
2. Bought November '89 soybeans, placing stops at 660, close only. As of today's flash update, we have accepted profits and covered short Canadian dollar positions. The next update will be Wednesday, September 14, after market close.

Wednesday, September 14: No changes or new recommendations.

Friday, September 16: No changes or new recommendations.

The market letter is being written this weekend. Mailing date September 20.

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Subscription Enquiries
Friedberg's Commodity & Currency Comments
347 Bay Street
2nd Floor
Toronto, Ontario, Canada
M5H 2R7
(416) 364-1171

Trading Accounts
All enquiries concerning trading accounts should be directed to Friedberg Mercantile Group
347 Bay Street
Toronto, Ontario M5H 2R7
(416) 364-2700

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