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# The revenue maximizers

Opec, or at least the inner-Gulf producer group, has finally come to its senses. The important point is not defending a particular, any particular, price level but asking oneself: What prices times volume will maximize my revenue?

The exercise is not without risk. For example, prices may drop in half, but volume may not even double (demand is not elastic, at least in the near to medium term); or, for example, prices drop to one third and *not* everyone in Opec is in a position to at least triple output, putting many Opec members in a worse position then they have been to date. (Chart 1 tells us that *no one*, at this time, is in that position — but, of course, in the long run, capacity can easily be expanded further in Saudi Arabia, Iran, Iraq, and a few other countries.)

Balancing these risks are three major "upside" considerations.

- First, Opec could begin to regain market share, displacing the new kids on the block. At some point, non-Opec production, now put at over 30 million barrels per day (b/d), could begin to shrink, and Opec would gain revenue even if world demand is not perfectly elastic.
- Second, new oil and gas exploration could be put on hold, removing potential future supply and strengthening Opec's hand beyond the turn of the century.
- Third, and most importantly, a low oil price would discourage conservation. In the medium to long run, it may even increase consumption by, at the very least, regaining its sliding share of the energy market.

At any rate, Opec has little choice but to take the risks. Thanks to an artificially high nominal price, Opec revenues have been falling steadily since 1981 (Chart 2).

Back to the crucial question: What price will maximize Opec revenue? Little econometric work has been done in this area. First, because few doubted Opec's will and determination to defend posted prices, assuming along with their energy czars that supply and demand for oil were highly inelastic (would not respond to price concessions). Second, because an historical analysis of consumption would have to incorporate an unquantifiable stocking phenomenon that resulted from the very fear that Opec was in a position to determine prices. More specifically, genuine demand for oil, leaving aside inventory buildups (including massive and persistent buying by the US and Japanese governments) is a great deal lower then what appears. Opec has been able to coax users into holding far greater inventories than warranted in a freely traded commodity. As a result, historical consumption figures are flawed.

We are left with two approaches. One is to calculate a "fair" price for oil, which assumes that oil trades like any other commodity. The CRB (Commodity Research Bureau) index stands today at 240 with a 1967 base equal to 100. In other words, raw material prices have risen 140% since 1967. At that time, posted Persian Gulf prices were in the vicinity of $2/barrel. Ergo, simple Simon says that "fair" nominal oil prices could be the range of $5/barrel. It is, incidentally, this $5/barrel price that we have been using for the past number of years (since at least 1982) as our ultimate downside target.

Then there is the "let's see" market approach. Let Opec increase production gradually until it reaches near-term capacity, somewhere between 27.6 million and 30 million b/d. At first, destocking efforts will sink prices a great deal lower than dictated by the presumed equilibrium level. The market will require time to absorb the combined weight of Opec's production and a worldwide destocking effort. At this point, non-Opec production falls rapidly, allowing consumers to absorb the "overhang" and Opec's full production. If the inventory overhang is equal to 35 days of forward consumption (approximately 1.8 billion barrels), then non-Opec producers will have to reduce their output sufficiently to accom-

## In this issue

Is a credit implosion imminent? We look at the thrifts for an answer. The yield curve is once again flattening, and the effects could be devastating. We respect the tapes in currencies and we follow the bouncing bear in gold. Also... wheat, sugar, cattle, the exotics, and Friedberg Capital Markets. Contributions by Albert D. Friedberg, Steve H. Hanke, Daniel A. Gordon, and Michael D. Hart.

modate the absorption of this inventory liquidation *plus* Opec's approximately 10 million b/d output increase. If accomplished over 120 days, non-Opec producers will have to slash output by 25 million b/d, an 80% cut! Obviously, the lengthier the process, the lower the non-Opec producer short-term pain.

To accomplish such a dramatic non-Opec output cutback, prices will have to drop in all probability, *well below* \$5/barrel, shutting out the North Sea but leaving Mexico and possibly the USSR as continuous producers.

Once destocking has been completed, non-Opec production can regain *some* of its present capacity utilization: Opec's gain will be non-Opec's loss and, grosso modo, 10 million b/d will have shifted from one region of the world to the other. In the long term, further erosion of non-Opec's share will take place, as Gulf producers gear up to much higher levels of production.

The "let's see" market approach says that in the near term, prices will literally collapse (as the overhang is absorbed). Sometime later (probably no less than four to six months and no more than nine to 12 months), prices will recover somewhat and tend towards equilibrium, a blurry and even unknown point, but one that surely exits.

Our cloudy market sense tells us that near-term prices will fall to \$2.50-\$3.00/barrel; medium term they recover to \$7-\$10/barrel; and long term they fall back below \$5/barrel (1988 dollars) as technology continues to "cheapen" production costs and offer substitution possibilities.

***STRATEGY:*** *We covered short positions on the December closing above 13.55, as per Hotline Update of Oct. 11, showing good profits and ultimately reentered the short side of the market this week, via January '89 crude oil, risking 1465, close only, as per Hotline of Oct. 20.*

**Chart 1**

| OPEC MEMBERS | QUOTA | (m b/d) CAPACITY |
|---|---|---|
| Saudi Arabia | 4.3 | 8.5 |
| Iran | 2.4 | 3.0 |
| Iraq | 1.5 | 2.7 |
| UAE | 0.9 | 2.2 |
| Kuwait | 1.0 | 2.0 |
| Qatar | 0.3 | 0.5 |
| Nigeria | 1.3 | 1.8 |
| Libya | 1.0 | 1.5 |
| Algeria | 0.7 | 0.8 |
| Gabon | 0.2 | 0.2 |
| Venezuela | 1.6 | 2.5 |
| Ecuador | 0.2 | 0.2 |
| Indonesia | 1.2 | 1.7 |
| | ----- | ----- |
| Total | 16.6 | 27.6 |

**Chart 2**

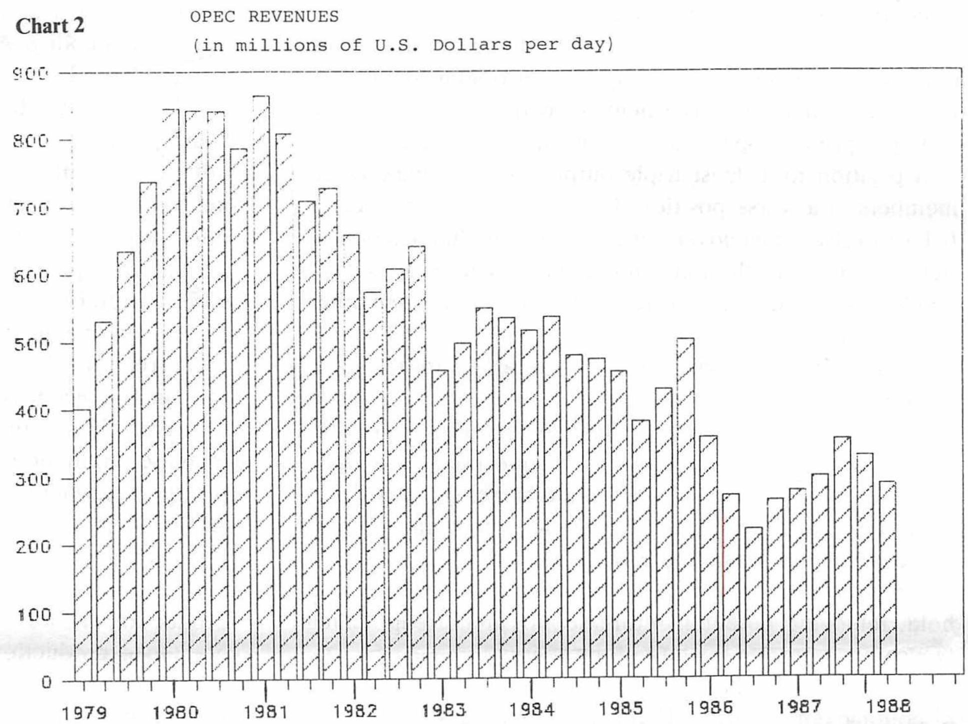


**Chart 3 – NYME CRUDE LIGHT DEC 88**

***THE ECONOMY***

# Backsliding into a credit implosion?

During the 1960s and 1970s, credit (debt) relative to the money supply (M2) remained rather constant, with two dollars of credit being created on the back of each dollar of M2. However, this relationship came unglued in the 1980s. Today, three dollars of credit are being created with each dollar of M2. This credit explosion has caused us a great deal of concern because it has been accompanied by a deterioration in credit quality. To appreciate this, consider the increasing number of banks and thrifts that have failed to keep their heads above water during the nation's longest peacetime economic expansion (Chart 4).

During the past few years, we have expressed our misgivings about these credit market developments on six different occasions (for our most recent installment, see *FC&CC*, April 26, 1987). In 1983, we also republished *A World in Debt*, which was authored by Mr. Freeman Tilden in 1935. The most recent string of billion-dollar thrift bailouts causes us to once again ask, "How will this credit orgy end?"

## The troubled thrifts

To address this question, we focus on the most troubled segment of the credit industry: the thrifts. Chart 5 shows that the industry is weak, although not uniformly so. Indeed, there is a relatively healthy segment in the thrift industry. However, the weakest segment, which is concentrated in Texas and California, poses a serious threat to the "healthy" thrifts, as well as to the nation's entire credit system and economy.

The thrift industry is regulated by the Federal Home Loan Bank Board (FHLBB), and obtains deposit insurance from the Federal Savings and Loan Insurance Corporation (FSLIC). This insurance is available to thrifts on a flat-fee basis, and is not priced to reflect the risks that are associated with individual thrifts' portfolios. Moreover, the entire deposit "insurance" system is not priced and managed on an actuarially sound basis. As a confirmation of this fact, consider that the US Congress created the Financing Corporation (FICO) in 1987 to borrow funds for FSLIC, with government guarantees on the principal. This was required because FSLIC was out of funds (technically bankrupt). Although FICO has borrowed about $10 billion to date, most observers conclude that much more will be required to allow FSLIC to continue operations. (The estimates range as high as $100 billion.)

So much for the background sketch. How did the thrift industry get into such a mess? In a phrase, the mess has been created by politicians and regulators who have not allowed markets to govern the thrifts. Specifically, deposit insurance puts a wedge between depositors and real risk assessment. In consequence, as long as deposits are not at risk, depositors are unconcerned about the activities of thrifts and the riskiness of thrifts' portfolios. This creates a classic "moral hazard" problem: Depositors simply chase yields, regardless of the real risks, as long as their deposits are insured and not exposed to these risks.

In March of 1980, Congress arbitrarily increased the level of deposit insurance coverage to $100,000 from $40,000 per account. This was unaccompanied by any increase in the insurance premiums paid by the thrifts. Not surprisingly, deposits began to pour into the thrift industry.

With this type of moral hazard, there is no market regulator (depositors) to look over the shoulder of the thrifts. Hence, once a moral hazard is artificially established by the government, a regulator is required to govern the system. However, at about the same time that Congress increased deposit insurance coverage and the potential moral hazard, it actually deregulated interest rates and investment activities of the thrifts.

Thus, the deposit insurance coverage increase, coupled with deregulation, established an artificial, nonmarket system that was bound to go out of control. Sure enough, as new deposits flooded into the industry, gunslinging thrift owners, armed with their new powers, competed vigorously for deposits and deployed them in ever more risky ventures. If this weren't enough, the industry attracted some rather shady characters who engaged not only in risky investments but also in pure old-fashioned fraud. All this simply overwhelmed the government's examiners who were woefully understaffed and unskilled. In consequence, the newly created, nonmarket system spun out of control.

## Thrifts' problems contagious

The problems created by this moral hazard and the gunslinging thrifts spills over to all depository institutions, whether they be well-managed thrifts, credit unions, money market mutual funds, or banks. As these institutions scramble for market share, they must compete with the gunslingers. In consequence, they must offer competitive yields. But, to do this and maintain net interest margins, they must engage in more risky loans. Hence, credit standards and credit quality must fall and risks increase.

The artificially created competition leads ultimately to over-intermediation. For example, at present, about 20% of the credit unions' assets are deposits in thrifts. So, a good chunk of the deposits flowing into financial intermediaries simply goes from one intermediary to another. This leads to a great deal of waste in the form of pure redundant capacity in the depository industry. It also reduces credit quality in the system because some deposits work their way through the system to the most risky institutions. Our friend, Mr. Bert Ely, who is an expert on these matters, estimates that over-intermediation is at least running at the $100 billion to $150 billion level and growing.

Our phony deposit insurance and regulatory system that has been thrust on us by the Congress has gone out of control. Specifically, it has artificially diverted billions of dollars of our scarce national savings into depository institutions, which, in turn, have invested great chunks of it in a less-than-prudent manner. In short, the system has created a credit quality crisis, with the most marginal thrifts leading a competitive charge that has forced the "healthier" depository institutions to follow.

## The 'rescue' strategy

What is being done to deal with the thrift (credit quality) crisis? To date, a massive rescue strategy has been followed. It has allowed some of America's most astute investors to purchase loss-ridden thrifts. But, why would these investors throw good money after bad? Well, because they aren't.

In most cases, they are taking very little risk because they qualify for two types of guarantees. One covers reconstituted thrifts against losses from write-downs on sales of problem assets. The other guarantee specifies an interest yield that can be obtained on non-performing loans. This yield guarantee is attractive because no capital is required for the loans that qualify. Moreover, the yield guarantee starts at about 250 to 275 basis points over the cost of deposits and is phased out over time.

In consequence, it pays the new thrift owners to "warehouse" non-performing loans until the yield spread is phased out. At that time, if the dogs and cats remain as such, they will be unloaded because any losses from sales will be fully compensated through the guarantee on write-down losses.

Several factors have come together to produce this purchase and acquisition (with warehousing) strategy:

1. Real estate interests wish to have as much real estate artificially held off the market as possible, so that prices are held above their true market value.

2. Politicians don't want to resolve the problem. They suffer from the "not on my watch" syndrome.

3. Technocrats at FSLIC are broke. For them to resolve the problem, they would have to go to Congress, which would then have to write a mega-check to pay off depositors and liquidate insolvent thrifts.

It is interesting to observe how the technocrats, who don't face a profit-and-loss bottom line, rationalize the current strategy. It gives some clues as to the ill-conceived nature of their "solution" to the problem. The technocrats argue that warehousing is a cost-effective strategy because the value of the non-performing real estate loans has bottomed out, and that these loans are appreciating at a more rapid rate than the cost of carrying (warehousing) the assets. This argument is based on the premise that oil prices and real estate values will increase.

Over the years, we trust that we have offered enough analyses to demonstrate that soaring oil prices are not in the cards.

Now, what about real estate? Here, too, the prospects aren't too bright. Property markets usually hit bottom when rents are at least high enough to cover current financing costs. This has not yet occurred. For example, in Texas, the most troubled thrift state, commercial property values have fallen only by 20% to 40%, while rents (net of concessions) have dropped by 50% to 80%. This has left rents well below financing costs, and suggests that the real estate market still has a good way to fall. The huge warehousing of real estate loans also confirms what the market is already telling us. We must conclude that the FSLIC technocrats are simply engaging in wishful thinking.

## The real solution

As long as the bad apples are left in the barrel, the credit quality rot will continue to spread throughout the entire system, and the ultimate cost to the nation will mount. There is only one way to deal with a credit quality problem when it strikes a banking system. It is a policy previously recommended by Dr. Felix Somary, "The Raven of Zurich." Dr. Somary, an Austrian-trained economist and brilliant banker, always counseled that in credit quality crises, a one-time surgical intervention was required to rid the banking organism of its diseased parts before more, potentially fatal, damage occurred. In the case of the failed thrifts, bankruptcy should be declared, the assets should be liquidated, and the depositors paid off in accordance with their insurance coverage. In addition, the deposit insurance system must be reformed, so that the moral hazard is removed from the credit game. This could be accomplished by dramatically reducing the insurance coverage to something under $25,000 per person, rather than $100,000 per account.

Much as the politicians and technocrats ignored Dr. Somary in 1920, we believe that our counsel will not be followed today. Rather, politicians will continue to backslide and allow the credit quality problem to spread. However, at some point, the economy probably will slow, and the credit problems will be magnified. *When, and if, this occurs, it will send a traumatic shock through the credit system and dramatically alter bankers' views about credit quality. The goal of maintaining market share will lose its importance, and bankers will rapidly tilt their portfolios toward safer assets, namely government paper. This will create a credit implosion.* In consequence, it will become very difficult to obtain credit, even if the Federal Reserve supplies more than ample reserves to the banking system. This implosion will hit the real economy hard because it is so dependent on credit.

***Implications:*** If the strategy for dealing with the credit quality crisis is not altered, there is an increasing likelihood that, one day, the depository institutions will rush from low-quality to high-quality assets. Hence, a credit implosion and recession will result. At that point, high quality government paper will be the place to be.

Although our analysis doesn't lead to an immediate trade, it has strong implications about the possible future course of the economy. To monitor the situation, we will be watching depository institutions' balance sheets in an attempt to detect any shifts toward quality and liquidity.

**– Steve H. Hanke**

### Chart 4
### Problem banks and thrifts

| | Failed Banks[1] | Problem Banks[2] | Problem Banks as % of Total | Failed Thrifts[3] | Problem Thrifts[4] | Problem Thrifts as % of Total |
|---|---|---|---|---|---|---|
| **1980** | 10 | 217 | 1.5% | 11 | 16 | 0.4% |
| **1981** | 10 | 223 | 1.5 | 28 | 53 | 1.4 |
| **1982** | 42 | 369 | 2.5 | 71 | 222 | 6.6 |
| **1983** | 48 | 642 | 4.4 | 52 | 281 | 8.8 |
| **1984** | 78 | 848 | 5.7 | 28 | 434 | 13.7 |
| **1985** | 116 | 1.140 | 7.7 | 34 | 449 | 14.0 |
| **1986** | 138 | 1.484 | 10.1 | 49 | 460 | 14.3 |
| **1987** | 184 | 1.575 | 11.1 | 48 | 505 | 16.0 |
| **1988[5]** | 143 | 1.493 | 10.6 | 94 | 511 | 16.5 |

[1] *Includes commercial banks and FDIC-insured savings banks that were liquidated or sold to other banks. Does not include banks granted FDIC assistance in order to remain open.*
[2] *Banks on the FDIC's official "problem bank list."*
[3] *Savings and loan associations and FSLIC-insured savings banks that were liquidated or sold with financial assistance from FSLIC. Does not include "supervisory" mergers or thrifts kept open under the FSLIC Management Consignment Program.*
[4] *Thrifts whose net worth as a percentage of assets, measured by generally accepted accounting principles, was less than zero.*
[5] *Latest figures.*

Sources: *Federal Deposit Insurance Corporation, Federal Home Loan Bank Board*

### Chart 5 – Thrift income-statement data

(Second quarter 1988 income statement for FSLIC-insured institutions)

**Gaap Capital – Liabilities Ratio**

| | Less than 0% | 0% to 3% | 3% to 6% | Over 6% | Total |
|---|---|---|---|---|---|
| Number of Institutions | 495 | 394 | 870 | 1.333 | 3.092 |
| Total Assets ($Bil.) | $187.5 | $219.4 | $547.8 | $335.3 | $1.290.0 |
| Mortgage Interest | 5.57% | 6.21% | 6.63% | 6.72% | 6.43% |
| Fees | 0.27 | 0.45 | 0.42 | 0.34 | 0.38 |
| Other Interest | 1.60 | 1.81 | 1.59 | 1.78 | 1.68 |
| Net Subsidiary Income | -0.50 | 0.10 | 0.10 | 0.13 | 0.02 |
| Other Operating Income | 0.18 | 0.15 | 0.12 | 0.19 | 0.15 |
| Total Operating Income | 7.12% | 8.72% | 8.86% | 9.16% | 8.66% |
| Interest On Savings | 6.41% | 5.13% | 4.94% | 5.33% | 5.29% |
| Interest On Borrowings | 1.89 | 1.78 | 1.70 | 0.93 | 1.54 |
| Personnel Expense | 0.76 | 0.72 | 0.71 | 0.79 | 0.74 |
| Other Operating Expense | 1.42 | 1.19 | 1.07 | 1.08 | 1.15 |
| Total Operating Expense | 10.48% | 8.82% | 8.42% | 8.13% | 8.72% |
| Net Operating Income | -3.36% | -0.10% | 0.44% | 1.03% | -0.06% |
| Profits On Sale Of Assets | 0.34% | 0.28% | 0.36% | 0.16% | 0.29% |
| Other Nonoperating Income | 0.08 | 0.04 | 0.03 | 0.03 | 0.04 |
| Total Nonoperating Income | 0.42% | 0.32% | 0.39% | 0.19% | 0.33% |
| Losses On Sale Of Assets | 0.30% | 0.17% | 0.11% | 0.12% | 0.15% |
| Other Nonoperating Losses | 0.17 | 0.04 | 0.03 | 0.03 | 0.05 |
| Provision For Losses | 6.33 | 0.57 | 0.17 | 0.21 | 1.15 |
| Total Nonoperating Expense | 6.80% | 0.78% | 0.31% | 0.36% | 1.35% |
| Net Nonoperating Income | -6.38% | -0.46% | 0.08% | -0.17% | -1.02% |
| Net Income Before Taxes | -9.74% | -0.56% | 0.52% | 0.86% | -1.08% |
| Net Income After-Taxes | | | | | |
| ROA | -9.68% | -0.45% | 0.44% | 0.65% | -1.13% |
| Dollars | ($4.541) | ($246) | $399 | $542 | ($3.646) |

## *INTEREST RATES AND STOCK INDEX FUTURES*

# The inverting yield curve

The mysteriously persistent downtrend in the money multiplier (ratio of M1 to Monetary Base) has contained M1 growth to a modest year-over-year 4.6% increase. One must assume that the Fed is aware of the multiplier "problem" and is content not offsetting its contractionary influence.

More significantly, in the face of a slight drop in credit demand (Chart 6), the Fed has not relented its grip on Fed funds, which now stand at 8.25%. This may be attributed to the weaker dollar of recent weeks and the expectations that economic indicators in coming weeks will not reveal any further economic "softening."

Once again, the yield curve is flattening (see Chart 7). *This phenomenon bears watching, because it could have a devastating impact* on money market instruments, long-term bonds, and stock prices.

The deterioration in stock market breadth is nothing less than spectacular. The inability of the cumulative advance/decline (Chart 8) and the Value Line Index (Chart 9) to better the June highs, reflects neatly on the state of the market: takeover and LBO mania is heavily concentrated on the multi-billion dollar category, and therefore the large capitalization stocks.

In some remote way, these takeovers and LBOs are similar to the nifty-fifty craze of the early '70s. The first difference, of course, is that most buyers now are entrepreneurs with little money of their own and lots of credit (compared with the stolid institutional "cash" buyers of 1972). The second difference is that the game is relatively much bigger now than it was then, bringing along a threat to the real economy, which was not the case 15 years ago.

An argument is being made that the withdrawal of equities resulting from these deals must be bullish. Under normal circumstances, this would be 100% true. However, the deals are *ultimately* financed at least partially by junk bonds, a form of equity – with a similar downside and a limited upside. In effect, the reduction in equities is partially offset by an *increase* in junk bonds outstanding.

While the bullish effect is thus minimized, it is obvious that if the process were to go on indefinitely, and bank credit were to accommodate these deals, the "float" of tradeable public securities would diminish greatly, and the bulls would have a good case. On the other hand, the economic instability created by such megaleveraging would put a very large discount on the balance of securities. Thus we would be back to square one.

Poor breadth figures leave little doubt that we are in bear market. The deal craze, however, is intensifying, and it is becoming harder to pick a turning point. Only an invented yield curve, if and when it materializes, will do the trick.

***STRATEGY:*** *The deal craze and the increasing level of "chutzpa" suggests an interesting trade: selling the small cap Value Line Index and buying the large cap S&P 500 index (see Chart 10).*

*Short positions in December '88 S&P 500 were stopped out as the cash index bettered 280. March '89 puts, however, should be maintained.*

**Chart 7 – YIELD CURVE**

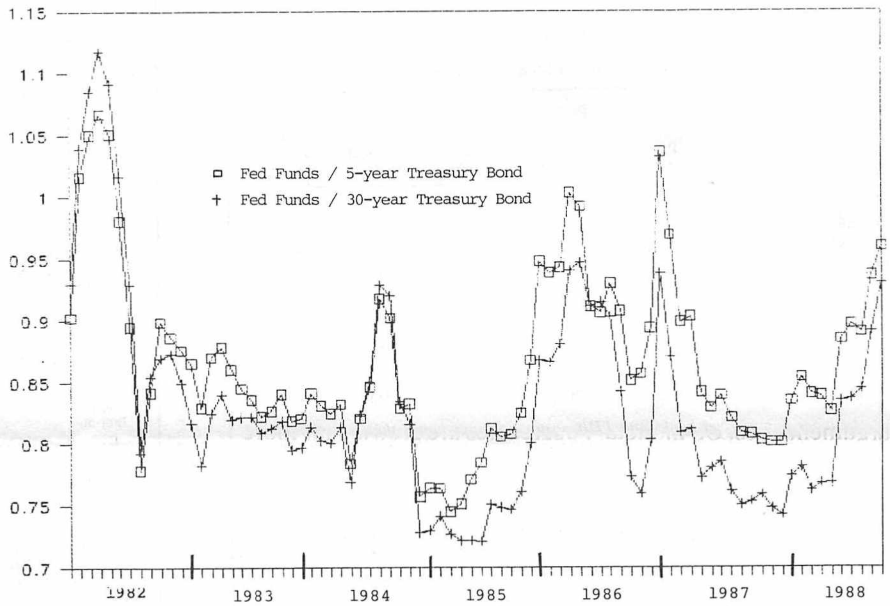


**Chart 6 – CREDIT DEMAND**

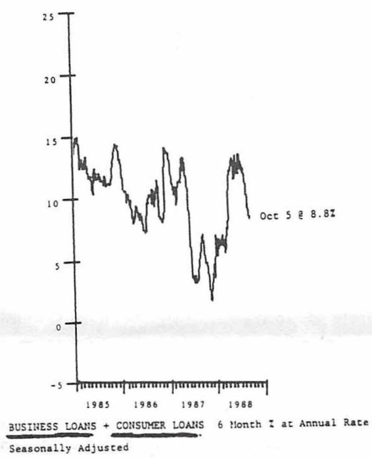


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**Chart 8**

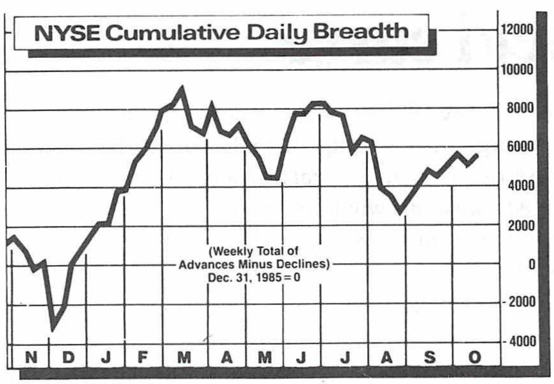


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**Chart 9 – VALUE LINE INDEX**

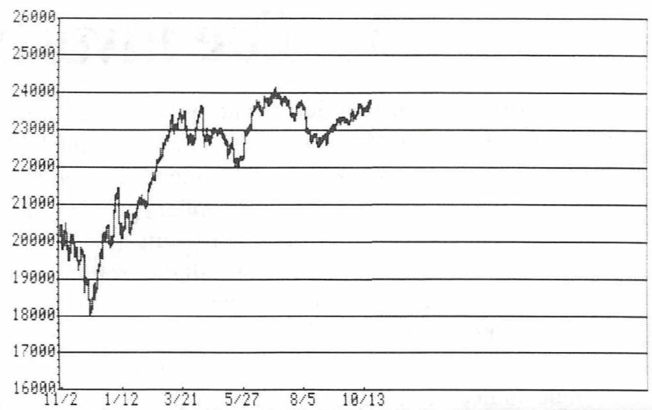



**Chart 10 – S&P 500/VALUE LINE**

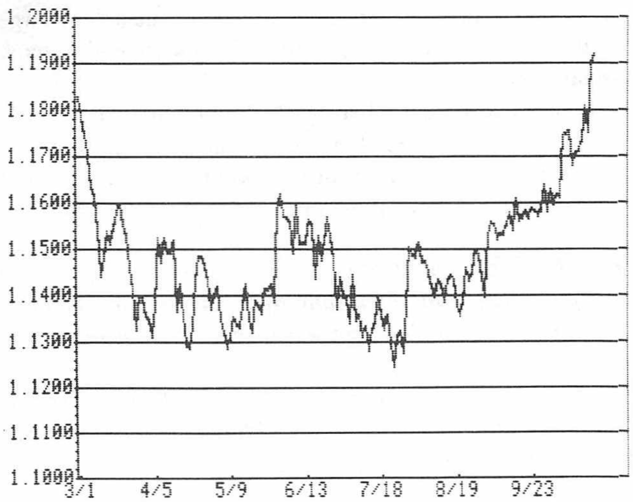
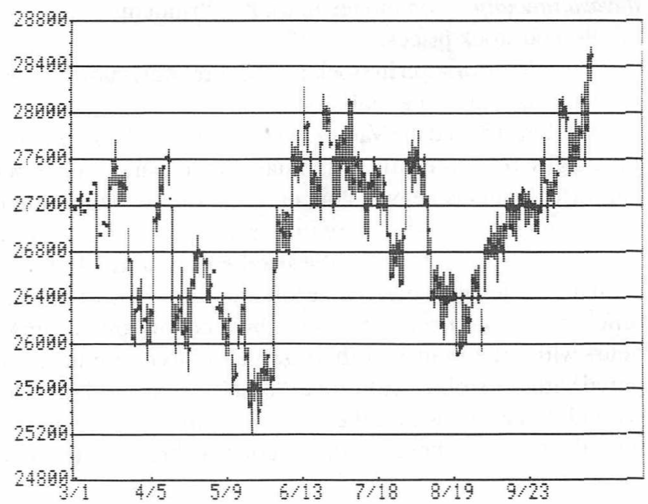



**Chart 11 – S&P 500 DEC 88**



## CURRENCIES

# Don't fight the tape?

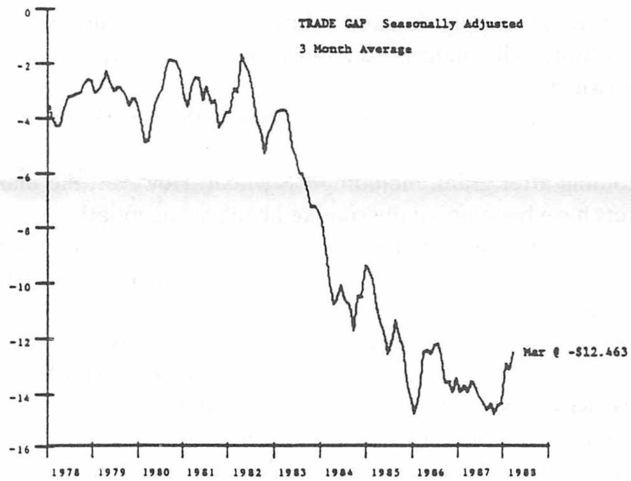
The US dollar has once again come under pressure on concern that 1) its trade balance deficit is not shrinking as much as hoped for and 2) US economic activity "seems" to be slowing, implying lower interest rates.

We buy neither of these two arguments. The trade balance *is* improving, albeit slowly (see Chart 12), and at any rate it has become a non-event (as we pointed out in the August issue), for two reasons: First, because it is no longer deteriorating — and markets need momentum — and second, the deficit is contracting in relation to GNP. As far as the second argument goes, US monetary aggregates are growing far more slowly than the Japanese or German counterparts, and alone among the three, its yield curve is flattening (see Chart 7).

We think, rather, that the sudden weakness is a case of nerves that very often makes for *double bottoms*. Sentiment on this reaction, however, has not moved to extreme levels (*last* week's bullish consensus on the US dollar was still a relatively high 36%) and therefore the "tape action" should be respected.

***STRATEGY:*** *Having been stopped out of short yen, DM, and EMS currencies, we stand aside with the intention of moving back to US dollars when bearish sentiment becomes more extreme. Keep in close contact via the Hotline.*

Chart 12




C.J. Lawrence

## PRECIOUS METALS

# The bear bounces

Gold prices found good support at $394/oz., basis nearest Comex contracts, as we had anticipated (see *FC&CC*, Sept. 18), a level that represented a 50% retreat of the bull move that began in 1985.

The market continues to "act" poorly, both in relation to other precious metals and in relation to the CRB. The bear trend is well entrenched, aided by huge production increases and cyclically weak inflation readings.

***STRATEGY:*** *We continue to favor the intra-commodity (gold-) bear spreads: short gold/long CRB and short gold/long silver in appropriate dollar ratios (see last month's issue of* FC&CC*).*

**Chart 15 – DEC 88 GOLD/DEC 88 SILVER**

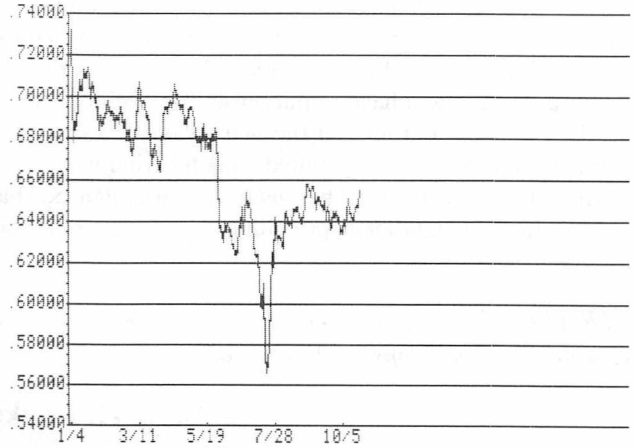
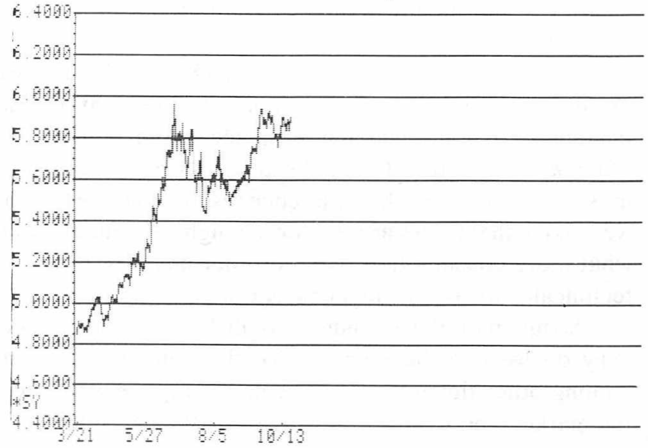



**Chart 16 – DEC 88 CRB/DEC 88 GOLD**



## WHEAT

# The Russians are coming

Since our last writing, the USDA has made new estimates of wheat stocks: They were 2240 million bushels, or 23% below year-earlier figures. With the wheat harvest in and stocks counted, we know the supply side of the market. The only issue is demand. When this market takes off, it will be demand-driven, not supply-shocked. Moreover, this demand, which we think will materialize, must come, in part, from the Russians.

Our view is consistent with that of the USDA: In their October report they tell us, in short, that the Russians are coming after grain, including US wheat. However, the markets have become totally spooked because negotiations over a long-term trade agreement (LTA) with the Soviets on grain broke down earlier this month. That the spooking is real can be seen by observing the recent fall in wheat prices and the dramatic reduction in the market's backwardation.

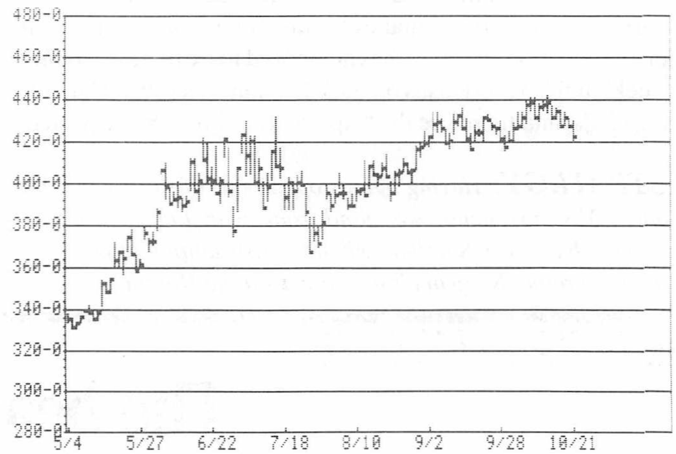
This leads us to ask, "Of what importance is an LTA with the Russians?" From our perspective, the issue of an LTA amounts to nothing more than a tempest in a teapot. The LTA that lapsed on September 30 was entered into because the Soviets wanted protection from another US grain embargo. Hence, they demanded and obtained an LTA.

At present, Gorby feels comfortable enough with Ron, so that the Soviets feel no threat of another embargo and consequently are in no rush to get locked into another LTA. Since export subsidy rates are not part of the LTA, we anticipate that the Russians' purchases of wheat will remain the same, with or without an LTA. If Russians want wheat, they will buy it. In consequence, we anticipate that the current hand-wringing over the failure of the USSR and US to sign an LTA will soon stop, and the market will once more begin its upward climb.

**STRATEGY:** *Having liquidated December wheat as per our Hotline Update of Oct. 21, look to reinstate long wheat positions via the purchase of March '89 wheat at the 402-405 level.*

**– Steve H. Hanke**

**Chart 17 – CBT WHEAT MAR 89**




## SUGAR

# Moving into stronger hands

We continue to update our world sugar balance. The most recent scrubbing of the data produced the balances shown in Chart 18. The picture remains roughly the same as it has since May 1987, when we began to indicate that the fundamentals were setting themselves up for a bull market in sugar. We should note that our ending stocks as a percent of disappearance are somewhat lower (hence, more bullish) than other well-publicized figures because our consumption figures are a bit higher. This difference results from the fact that we assume that prices are still low enough to stimulate somewhat more consumption than do other analysts. (Speaking technically, we assume higher sugar price elasticities.)

So much for the unchanging bullish sugar fundamentals. Why do we like the long side of the market at present? Among other things, there as been a complete wash-out in the market, and the price at which we established long positions was "low." The other factor that we consider bullish is the fact that Philipp Brothers took delivery on virtually all the "October sugar." This amounted to 382,000 tonnes. If experience is a guide, this means that sugar is in strong hands. In short, buyers (and Philipp Brothers knows full well who these buyers are) will have to purchase from Philipp Brothers. This type of "corner" on the market is not a new ploy with Philipp Brothers. They pulled one off earlier when they "cornered" the market for Thai sugar. In consequence, Thai sugar went to a significant premium over the March New York contract.

**STRATEGY:** *You are long March '89, per the Hotline. Remain long. Place stops at 895, close only.*

**– Steve H. Hanke**

Chart 19 – N.Y. #11 SUGAR MAR 89

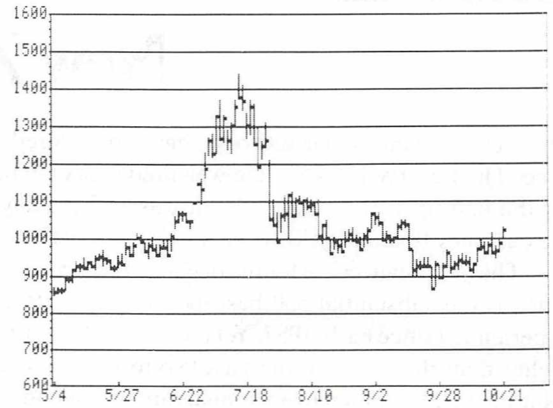



**Chart 18**

**World Sugar: Production, Disappearance, Stocks, March Future Closes**

| Crop Year | Production 1,000 Tonnes | Production % of 3 yr. average | Disappearance 1,000 Tonnes | Disappearance % of 3 yr. average | Ending Stocks 1,000 Tonnes | Ending Stocks % of disapp. | March Future Avg. of closes Oct. 1-Dec. 31 |
|---|---|---|---|---|---|---|---|
| 85/86 | 98.696 | 99.0 | 101.347 | 104.0 | 36.853 | 36.4 | 5.90¢ |
| 86/87 | 104.547 | 105.6 | 106.336 | 106.8 | 35.064 | 32.9 | 6.64 |
| 87/88 | 104.481 | 103.2 | 107.588 | 104.8 | 31.957 | 29.7 | 8.32 |
| 88/89 | 107.500 | 104.8 | 110.957 | 105.6 | 28.500 | 25.7 | 12.50 |
| 89/90 | 109.000 | 103.3 | 109.500 | 101.1 | 28.000 | 25.6 | 15.00 |

## CATTLE

# Bullish on beef

The 13-state Cattle on Feed report, as at October 1, indicates that we are moving next year into the smallest feed cattle supply since 1982.

***STRATEGY:*** *Remain long, raise stops to 71.75, basis February 1989, close only.*

Chart 21 – CME LIVE CATTLE FEB 89

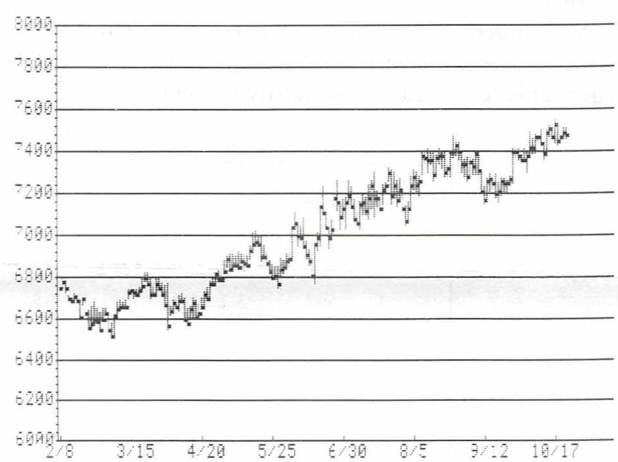



**Chart 20**

**13-State cattle on feed Oct. 1 – USDA**

CATTLE/CALVES DATA (1,000 HEAD)

| | PCT-X | 1988 | 1987 |
|---|---|---|---|
| ON FEED OCT 1 | 95 | 8.576 | 8.992 |
| PLACED ON FEED-Y | 90 | 5.959 | 6.590 |
| MARKETED-Y | 102 | 6.151 | 6.022 |
| INTENDED SALES-Z | 100 | 5.560 | 5.583 |
| OTHER DISAPPEAR-Y | 92 | 223 | 242 |
| ON FEED JUL 1 | 104 | 8.991 | 8.666 |

X-1988 AS PCT OF 1987. Y-JUL-SEP. Z-OCT-DEC. NOTE – OTHER DISAPPEARANCE INCLUDES DEATH LOSSES AND FEEDLOT MOVEMENTS.

## POTPOURRI

# Beans and pounds and Nikkei Dow

Remain long November '89 soybeans and March '89 soymeal with stops at $6.60/bu. and $219/ton respectively, close only. We are short 90-day Sterling interest rate deposit at 88.70 (equivalent to 11.30%), betting that the UK boom, which shows no sign of abating, will require an increase of the base rate to 14% from 12% at the present; place initial stops at 89.65, close only... We are short the Nikkei Dow, with initial stops at 28500, looking for a lengthy 25%-50% decline...

## THE EXOTICS

# New Zealand dollar

The New Zealand dollar has once again re-entered a value zone. The Reserve Bank's trade-weighted index fell below 60 for the first time since May 1987; it was 61.2 the day before the currency floated at US$ 0.4444 in March 1985.

The proximate cause for the decline of the trade-weighted index is the substantial 550 basis-point fall in interest rates experienced since early 1987. Yet real interest rates are today higher than they were in the past two to three years, as the inflation rate has fallen to an annual rate of just under 4% per annum, and nominal rates are still in the 13% to 14% range for term paper.

Finance Minister Roger Douglas is extremely determined to bring the inflation rate down to the 0% to 2% annual rate (so much so that the employment contract for the new central bank governor will be inversely correlated to the movement of the consumer price index!!!). In the interim, monetary aggregates have decelerated markedly in the past several months. Seasonally-adjusted M3 money supply grew an estimated 0.6% in August against a 1.4% rise in July and a 2.5% rise in August 1987. Year-on-year M3 rose 9.9% compared with 12.3% in July and 18.7% in August 1987. Year-on-year M1 grew 4.8% against 7.5% to July and 52.4% to August 1987.

At the same time, economic activity continues to weaken. The GDP annual growth at constant 1982-83 prices fell .4% in the year ended June 1988 against a minuscule rise of 1.2% in the year ended June 1987. It should be noted that retail sales in volume terms have been relatively flat for the last four years. This severe case of austerity is a necessary precondition for achieving an outward-looking trade adjustment. In fact, the trade surplus has been improving steadily during this period. For the 12 months to August 1988, the surplus on merchandise trade was NZ$1,080 million, and figures for September should indicate a surplus of NZ$1330 million.

The current account, burdened by heavy interest payments on the accumulated foreign debt, is also improving. The deficit to the 12 months ended in July 1988 was NZ$600 million lower than the 12-month deficit to July 1987. The fall in interest rates and the continued improvement in trade should stimulate further progress in the country's current account and help stabilize the growth of foreign debt.

What New Zealand needs most is continued restraint in consumer expenditures, allowing for a shift in resources to the export sector. Fiscal and monetary policies are well positioned for this role. The recent tax cuts (which make New Zealand a far better tax haven than Australia) should go a long way towards encouraging an increase in domestic savings and thus a substantial reduction in the current account deficit.

***STRATEGY:*** *We recommended over our Hotline dated Oct. 7 the purchase of New Zealand dollar bonds, now yielding around 14% with an allocation not to exceed 25% to 30% of a global portfolio. We also recommended the purchase of New Zealand dollar forwards with the objective of capital appreciation and the capture of the forward discounts. Limits for the purchase of New Zealand dollar forwards and bonds should not exceed .6300, basis spot.*

**Chart 24**

| | | | | BASKET: U.S. 25%, Australia 30%, Japan 29%, U.K. 16% | |
|---|---|---|---|---|---|
| YEAR | U.S. DOLLAR PER NEW ZEALND DOLLAR (PERIOD AVG.) | U.S. 1970=1.00 | U.S. 1978=1.00 | 1970=1.00 | 1978 =1.00 |
| 1967 | 1.3554 | 0.8253 | 1.1096 | 0.8732 | 0.8834 |
| 1968 | 1.1170 | 1.0019 | 1.3470 | 1.0126 | 1.0244 |
| 1969 | 1.1152 | 1.0071 | 1.3541 | 1.0098 | 1.0215 |
| 1970 | 1.1193 | 1.0000 | 1.3445 | 1.0000 | 1.0116 |
| 1971 | 1.1416 | 0.9232 | 1.2412 | 0.9499 | 0.9609 |
| 1972 | 1.1952 | 0.8547 | 1.1491 | 0.9133 | 0.9239 |
| 1973 | 1.3615 | 0.7354 | 0.9888 | 0.8655 | 0.8666 |
| 1974 | 1.4004 | 0.7136 | 0.9594 | 0.8577 | 0.8677 |
| 1975 | 1.2157 | 0.7847 | 1.0551 | 0.9713 | 0.9826 |
| 1976 | 0.9963 | 0.8663 | 1.1647 | 1.1107 | 1.1237 |
| 1977 | 0.9708 | 0.8270 | 1.1119 | 1.0804 | 1.0929 |
| 1978 | 1.0378 | 0.7438 | 1.0000 | 0.9885 | 1.0000 |
| 1979 | 1.0229 | 0.7390 | 0.9936 | 0.9775 | 0.9888 |
| 1980 | 0.9742 | 0.7513 | 1.0101 | 1,0036 | 1.0153 |
| 1981 | 0.8700 | 0.8056 | 1.0831 | 1.0756 | 1.0881 |
| 1982 | 0.7519 | 0.8507 | 1.1437 | 1.1194 | 1.1324 |
| 1983 | 0.6688 | 0.9195 | 1.2362 | 1.1962 | 1.2102 |
| 1984 | 0.5785 | 1.0448 | 1.4048 | 1.3513 | 1.3670 |
| 1985 | 0.4984 | 1.0871 | 1.4615 | 1.3533 | 1.3691 |
| 1986 | 0.5253 | 0.9292 | 1.2492 | 1.1758 | 1.1894 |
| 1987 | 0.5922 | 0.7758 | 1.0430 | 1.0057 | 1.0174 |
| 1988 (1Q) | 0.6621 | 0.6413 | 0.8622 | 0.8411 | 0.8508 |
| 1988 (2Q) | 0.6834 | 0.6249 | 0.8402 | 0.8816 | 0.8918 |

Above 1.00 = undervalued
Below 1.00 = overvalued

## FRIEDBERG CAPITAL MARKETS

### Chart 26
**Breakeven exchange rates for US$ – based investor**

This analysis shows a "snapshot" of the relationship between interest rate differentials and rates of exchange. The breakeven rate measures how far the foreign currency has to devalue (for NZ$, A$, 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 October 20 '88.

| | U.S. $ | NEW ZEALAND $ | AUSTRALIAN $ | DEUTSCHEMARK | SWISS FRANC | JAPANESE YEN | DANISH KRONE |
|---|---|---|---|---|---|---|---|
| 1 year | 8.13% | Wells Fargo 16⅛ 5/12/89 Yields 13.56% (.593 NZ/US) | | | | | |
| 2 year | 8.37% | McDonalds 16¾% 15/8/90 yields 13.37% (.568 NZ/US) | | | | | |
| 4 year | 8.53% | | | | | | World Bank 9¾ 20/11/92 yields 9.70% (7.25 DKr./US) |
| 5 year | 8.55% | Tourist Hotel 0% 4/6/93 yields 14.56% (.475 NZ/US) | | | | Canada 5⅝ 23/7/93 yields 4.78% (106.2 US/JY) | |
| 6 year | 8.62% | | Com. Bk. of Aus. 14% 1/7/94 yields 13.25% (1.64 A/US) | | | | |
| 8 year | 8.75% | | | Hydro Quebec 5½ 1/5/96 yields 6.91% (1.57 US/DM) | | | |
| 10 year | | | | | Australia 5% 30/10/98 yields 4.78% (1.04 US/SF) | | |
| Spot Exchange Rate | N/A | .6218 | .8229 | 1.8002 | 1.5205 | 126.70 | 6.945 |

**For example, in parentheses, since a US$ based investor would receive 543 basis points (k356-813) by holding the Wells Fargo NZ$ Bond, the NZ$ can depreciate to .593 NZ/US from the present spot exchange rate of .6218 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 27
**Foreign currency bond investment yearly performance**
**Sept. 30/87 - Sept. 30/88**
**For a US$ Based Investor**

| Denominated in | Had you invested on Sept. 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$ * |
|---|---|---|---|---|---|
| New Zealand Dollar | Wells Fargo 16⅛% 5/12/89 NZ$ | -5.91 | +2.51 | +15.17 | +11.77% |
| West German Deutschemark | Quebec Hydro 5½% 1/5/96 DM | -2.23 | +7.07 | + 5.38 | +10.22% |
| Japanese Yen | Canada 5⅝% 23/7/93 JY | +8.53 | +4.11 | + 6.10 | +18.74% |
| Swiss Franc | Australia 5% 30/10/98 SF | -4.01 | +3.18 | + 4.80 | + 3.97% |
| Australian Dollar | C.I.B.C. 13% 13/3/91 A$ | +9.48 | -2.74 | +14.23 | +20.97% |

*Assumes that all coupons were reinvested fully.

### Chart 28
**Foreign Currency Bonds**

Date: October 20, 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 NEXT PAY DATE |
|---|---|---|---|---|
| **NEW ZEALAND DOLLAR DENOMINATED BONDS** | | | | |
| TORONTO DOMINION BANK 02/04/90 18% RRSP eligible | 104 3/4 | 105 1/2 | 13.30 | 02/04/88-02/04/89 |
| BANK OF NOVA SCOTIA 15/09/89 18 1/2% RRSP eligible | 102 3/4 | 103 1/2 | 12.80 | 15/09/88-15/09/89 |
| WELLS FARGO (semi annual) 12/05/89 16 1/8% | 100 3/4 | 101 1/2 | 13.56 | 12/05/88-12/11/88 |
| EASTMAN KODAK (semi annual) 15/02/89 17% | 100 3/8 | 101 1/8 | 13.25 | 15/08/88-15/02/89 |
| MCDONALD'S (semi annual) 15/08/90 16 3/4% | 105 1/8 | 105 7/8 | 13.37 | 15/08/88-15/02/89 |
| TOURIST HOTEL (N.Z.) 04/06/93 zero coupon | 52 | 53 1/2 | 14.56 | matures 04/06/93 |
| **AUSTRALIAN DOLLAR DENOMINATED BONDS** | | | | |
| COMMONWEALTH BANK OF AUSTRALIA 01/07/94 14% | 101 7/8 | 102 5/8 | 13.26 | 01/07/88-01/07/89 |
| WORLD BANK 15/03/93 12 3/4% RRSP eligible | 98 3/8 | 99 1/8 | 12.97 | 15/03/88-15/03/89 |
| CAN.IMP.BANK OF COMMERCE 13/03/91 13% RRSP eligible | 98 | 99 | 13.42 | 13/03/88-13/03/89 |
| **DANISH KRONE DENOMINATED BONDS** | | | | |
| WORLD BANK 20/11/92 9 3/4% RRSP eligible | 99 3/8 | 100 1/8 | 9.70 | 20/11/87-20/11/88 |
| STOCKHOLM 10/11/91 10 5/8% | 102 7/8 | 103 5/8 | 9.20 | 10/11/87-10/11/88 |
| **DEUTSCHE MARK DENOMINATED BONDS** | | | | |
| QUEBEC HYDRO 1/5/96 5 1/2 RRSP eligible | 95.80 | 96.55 | 6.91 | 01/05/88-01/05/89 |
| **SWISS FRANC DENOMINATED BONDS** | | | | |
| GOVT.OF AUSTRALIA 30/10/98 5% | 101 | 101 3/4 | 4.78 | 30/10/87-30/10/88 |
| **JAPANESE YEN DENOMINATED BONDS** | | | | |
| GOVT.OF CANADA 23/7/93 5 5/8% RRSP eligible | 102 3/4 | 103 1/2 | 4.78 | 23/07/88-23/07/89 |

**U.S.DOLLAR DENOMINATED FLOATING RATE NOTES**

| ISSUER | MAT.DATE | COUPON | BID | OFFER | CUR.COUP. | |
|---|---|---|---|---|---|---|
| UNITED KINGDOM | 24/9/96 | 3 mo.LIBID-1/8 (quarterly) | 100.01 | 100.31 | 8 1/16% | 24/09/88-28/12/88 |
| REPUBLIC OF ITALY | 30/4/93 | 3 mo Limean (quarterly) | 98.80 | 99.20 | 8.3125% | 29/07/88-31/10/88 |

**L.D.C. PAPER DENOMINATED IN U.S.DOLLARS**

*Simple yield
**Int.Rate of Return

| ISSUER | MAT.DATE/COUPON | BID | OFFER | CUR.COUP. | | |
|---|---|---|---|---|---|---|
| BANCO CENTRAL (restructured) De CHILE | 12mo.LIBOR +1 1/8 (annually) | 59 3/4 | 63 3/4 | 9.0625 | * 14.22% | 20/01/88-20/01/89 |
| ARGENTINA BONEX ser.82 | 15/2/92 LIBOR (sem.ann.) | .8420 | .8570 | 8 9/16 | ** 20% | 15/08/88-15/02/89 ammortized: 12½% of principal paid yearly |

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

## FOREX RATES & UPDATE

| Currency | Spot | 3-Month | 12-Month | Comments vis à vis US$ | Comments vis à vis DM (Spot DM: 1.7780) |
|---|---|---|---|---|---|
| Australian dollar | .8205-.8210 | .8100-.8110 | .7805-.7820 | Neutral | Neutral |
| *Belgian franc | 37.28-37.30 | 37.15-37.19 | 36.72-36.87 | Covered | Liquidate |
| *Danish krone | 6.8590-6.8620 | 6.8505-6.8575 | 6.8415-6.8820 | Covered | Liquidate |
| *Dutch guilder | 2.0055-2.0065 | 1.9899-1.9907 | 1.9420-1.9445 | Covered | Neutral |
| Greek drachma | 146.55-146.65 | 148.25-150.35 | 156.55-164.65 | Remain short | Remain short |
| *Hong Kong dollar | 7.8110-7.8120 | 7.8050-7.8070 | 7.7990-7.8060 | Neutral | Liquidate |
| Irish punt | 1.4960-1.4975 | 1.5000-1.5025 | 1.5110-1.5160 | Covered | Neutral |
| *Italian lira | 1326-1328 | 1325-1327 | 1356-1363 | Covered | Remain short |
| Kuwaiti dinar | .28050-.28070 | .27830-.27895 | .27360-.27540 | Remain short | Neutral |
| Malaysian ringgit | 2.6700-2.6710 | 2.6400-2.6450 | 2.5550-2.5760 | Neutral | Neutral |
| *New Zealand dollar | .6225-.6235 | .6140-.6165 | .5910-.5970 | Remain long | Neutral |
| *Norwegian krone | 6.6250-6.6300 | 6.6920-6.7020 | 6.8600-6.8800 | Cover | Neutral |
| *Portugese escudo | 147.40-147.90 | 148.80-150.05 | 153.50-156.70 | Cover | Remain long |
| Saudi Arabian riyal | 3.7500-3.7505 | 3.7525-3.7540 | 3.7585-3.7620 | Remain short | Remain short |
| Singapore dollar | 2.0060-2.0070 | 1.9915-1.9945 | 1.9585-1.9647 | Neutral | Neutral |
| Spanish pesetas | 117.70-117.80 | 118.60-118.80 | 121.40-121.90 | Remain short | Neutral |
| Swedish krona | 6.1850-6.1900 | 6.2125-6.2205 | 6.2825-6.3000 | Remain short | Neutral |

**Explanatory Notes**

*Indicates change in recommendation from last issue.

| | US$ | DM |
|---|---|---|
| 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, September 20:** The market letter is in the mail.

**Friday, September 23:** A number of arithmetic errors crept into our last FC&CC, dated Sept. 18. The errors do not in any way invalidate our conclusions.

We are mailing to you under separate cover these changes. In the interim, please note: on Page 1, first paragraph on the right side, 475 should read 310. On Page 2, second paragraph on the left, 250 should read 163, and $90-$100/oz. should read $80/oz.

Three new recommendations:

1. Lower stops on crude oil to 1540, basis December, close only.
2. Sell December T-bonds at the market, risking 89.00, close only.
3. **For hedgers only:** Sell December Canadian dollar at market, risking 8200, close only.

**Wednesday, September 28:**

1. Accept profits on half of your short crude oil positions. Lower stops on the balance to 1451, close only basis December.
2. Sell March 90-day short-term Sterling deposit at 88.70 or better. Place initial stops at 89.65, close only.

**Friday, September 30:** Repeat of September 28.

**Wednesday, October 5:** Two new recommendations:

1. Buy March sugar at the market, risking 875, close only.
2. Lower stops in crude oil to 1400, basis December, close only.

**Friday, October 7:** As mentioned Tuesday, we recommended buying March sugar at market, risking 875, close only.

Three new recommendations:

1. Lower stops on December crude oil to 1385, basis December, close only from Tuesday's suggested level of 1400.
2. Sell December Nikkei Dow at market. Place stops at 28500, basis cash.
3. Currency traders may buy New Zealand dollar forward contract with initial stops at 59.50, basis cash.

We recommend that bond investors should purchase New Zealand bonds yielding approximately 13½%. Recommended exposure is 25% of total bond portfolio.

**Tuesday, October 11:**

1. We are reconfirming stops on short Japanese yen positions of 130.00, basis cash, or approximately 77.55, basis December IMM, close only.
2. Raise stops on December wheat to 408, close only.
3. Lower stops on December crude oil to 13.55, close only.

**Flash update, October 13, 11:10 a.m.:** Reinstate short December Japanese yen positions at market, placing stops at 79.60, basis December, good anytime.

**Friday, October 14:** A recap as per Tuesday's update:

1. We raised stops on December wheat to 408, close only.
2. As per our revised stops of 1355, basis December, close only, we were stopped out of our crude oil positions on Wednesday. We are now flat.
3. As per our Thursday flash update, we are now once again short the December Japanese yen after having been stopped out, based on the 77.55 stop, close only. Our new stop on our short yen position is 79.60, basis December, good anytime. Keep in close contact for any further changes in this very volatile market.

**Flash update, Tuesday, October 18, 10:00 a.m.:** Reinstate a full short position in crude oil. Sell January crude oil at market, risking 1456, close only.

**Flash update, Thursday, October 20, 10:00 a.m.:** A quick run-up on the close yesterday just triggered our January crude oil stop close of 1456. Reinstate short January crude oil positions at market, placing stops at 1465, close only.

**Friday, October 21:** As per our flash update of Thursday 10:00, we are short January crude oil with stops at 1465, close only.

One new recommendation: Liquidate long December wheat positions at market.

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