FRIEDBERG'S

COMMODITY & CURRENCY COMMENTS

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US dollar: missing one ingredient

The fundamentals are in place.

The US dollar is "cheap" on a purchasing power parity basis. Monetary policy is tightening. The yield curve is inverting. Eurodollars yield 450 basis points more than comparable Euroyen and Euro-DM deposits. M1 is growing between five and seven percentage points *slower* in the US than in West Germany and Japan. The trade balance continues to improve, admittedly very slowly (see Chart 1) but improve nonetheless. And, as we demonstrated in earlier issues, the relative trade gap (percent of GNP) has definitely turned the corner. In a recession, the US *will* produce a surplus. Is that what the market wants?

Intervention at the 1.90-1.94 DM/$ level and 134-137 ¥/$ level, and agonizingly slow progress on the trade front, discouraged trend-following speculators from buying more dollars. A normal profit-taking reaction developed into a full-fledged run under the massive power of hot money flows. In this high-tech, computer-driven era, speculation has become highly destabilizing. Markets, in the short term, are made by chart-followers whose motto is "the trend is your friend." Fundamentals can safely be ignored: It is impossible to obtain an equilibrium point; at best, ranges — wide ranges — are compatible with any given level of trade and asset flows. Therefore, fluctuations of 10% to 20% are common. Exchange rates have become the football of bank (and other) traders.

But trends that move contrary to basic fundamentals must sooner or later reverse. How? The trend must gradually lose strength as the quality of those who push the trend deteriorates.

As an example, the first dollar sellers, in early September, can be credited for being highly responsive to technical factors and prospects of falling US interest rates (the economic slowdown phase).

The next group of dollar sellers pressed the incipient trend and hoisted the flag of stagnation on the trade front. The next group of dollar sellers needed "official" support in the form of a declaration by Mr. Feldstein that the yen would have to rise 20% to 25% in the next three years (see next article) to achieve a meaningful turn in our trade balance (a stale and inaccurate assessment).

The most recent dollar sellers don't need any excuse: After all, the trend is down. As more and more bears join this trend — for the mere sake of following the trend — the market becomes increasingly vulnerable to a reversal.

A deeply pessimistic consensus of opinion on the dollar would indicate that we have entered the last phase of the decline — the bears who sell simply because it must go lower. The level of bearish consensus on the dollar reveals the technical vulnerability of the bear trend.

Has the consensus on the dollar become bearish enough? Let the reader judge. Chart 2 is a weekly composite of opinions taken from *The Bullish Consensus*, California (it averages the bullish consensus of the DM, yen, SF, and British pound and *inverts* the figure to provide a bullish dollar consensus level).

Historically, important bottoms have been associated with readings of 20% or less over a number of weeks. We are not there yet.

Chart 3 appeared in *The Wall Street Journal* on November 17. Interestingly, the mean one-year expectation for both yen and DM lay just *above* the implicit (unbiased) one-year forward estimate. If those experts are right, buying one-year forwards of yen and DM will *not* show a profit despite their avowed bearishness. Once again, it appears that we are not there yet.

Curiously 1988-89 may be a replay of 1978-80. Then, the dollar bottomed out in November 1978, rallied, and came back down to test the 1978 lows in early 1980. Sterling, the DM, and SF exceeded their 1978 highs, but the yen fell far short of the 1978 highs. January 1980 marked the low of the US dollar for the next five years. Another double bottom now may be in the offing: The first one occurred in January 1988. Will the second one also occur 14 months later?

Be that as it may, we remain friendly to the US dollar, looking for a buying opportunity.

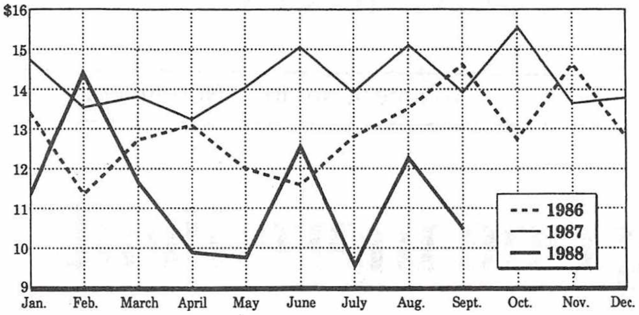
STRATEGY: *We are sidelined.*

In this issue

Chart 1

Tracking the Trade Deficit

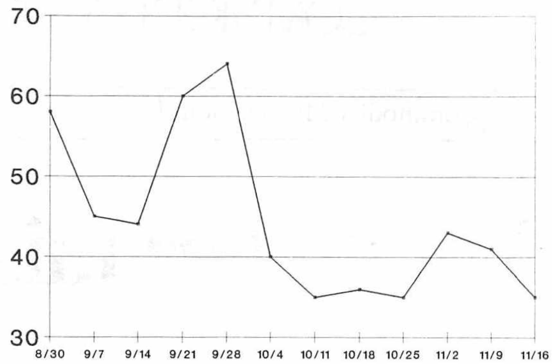
(In billions of dollars, seasonally adjusted)



Note: Monthly figures for 1986 aren't adjusted for undocumented exports to Canada; deficit based on imports, including insurance and freight.
Source: Commerce Department

Chart 2

U.S.$ BULLISH CONSENSUS



Source : Hadady Corp.

Chart 3

Economists See Dollar Falling Further in '89

	YEN	MARKS
David Resler, Nomura Securities	115-120	1.65
Robert Chandross, Lloyds Bank	112-117	1.62-1.66
Alan Lerner, Bankers Trust	135	1.90
David Wyss, Data Resources	110-115	1.60
Tadao Hata, Bank of Tokyo	115	1.68
John Paulus, Morgan Stanley	120	1.70
AVERAGE	119	1.695

Source: Wall St. Journal

Chart 4 – CME JAPANESE YEN DEC 88

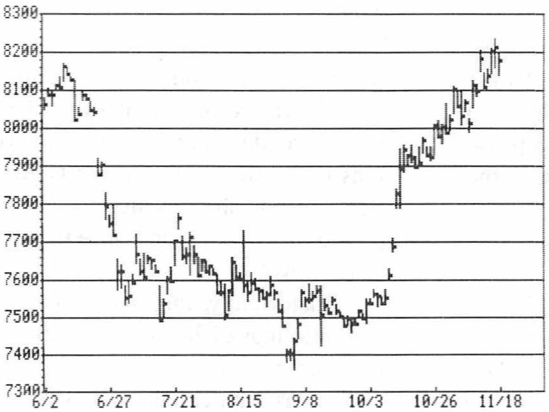


Chart 5 – CME DEUTSCHE MARK DEC 88

More dollar talk

The voting booths had barely closed before Professor Martin Feldstein, a sometime adviser to President-elect George Bush, rocked currency markets with a speech delivered at the American Stock Exchange. Professor Feldstein argued, as he has done repeatedly during the past few years, that the dollar *must* fall by 10% to 20% in the next three years.

We question the logic and evidence that has led Professor Feldstein to his pessimistic conclusion about the course of the dollar. Before we begin, allow us to make clear that we dispute the claim that the dollar *must* fall. This is not to predict that the dollar *will not* fall. Rather, we claim only that any predictions that are based on Professor Feldstein's faulty logic should not be relied upon.

Supply and demand

The exchange rate of the dollar is determined by the demand and supply of dollar assets. The dollar exchange rate will, therefore, fall when the supply of dollar assets exceeds the foreign demand for dollar assets (at the current exchange rate). The supply of dollar assets is determined, in large part, by our trade in goods and services with foreigners. When we purchase more goods and services from foreigners than we sell to them, we supply foreigners with dollar assets. These include US bank drafts, corporate equities, corporate bonds, government securities, real property, and other financial claims on US assets.

The supply of dollar assets to foreigners has increased rapidly in the 1980s: As late as 1981, the supply was actually negative, with the current account running a surplus of about $6.9 billion. By 1987, the supply of dollar assets had increased to about $154 billion, and in the first half of 1988 the supply had slacked off to an annual rate of $140 billion. Behind Professor Feldstein's assertion that the dollar must fall by 10% to 20% over the next three years is the general notion that foreigners' desire to continue accumulating dollar assets will wane. This implies that the US current account deficit (the supply of dollar assets) must be reduced. Professor Feldstein argues that this result can be obtained by a significant decline in the exchange value of the dollar.

More specifically, Professor Feldstein argues that no country can pay more than a fraction of its income to service debt owed to foreigners, and that the current interest rate differential between US and foreign rates implies an expected future rate of dollar depreciation that is too slow to bring about reductions in the supply of dollar assets to foreigners (the current account deficit). In consequence, US interest payments to foreigners will continue to rise. This, it is argued, is not sustainable. Hence, the dollar must decline more rapidly than the markets currently expect.

Feldstein's flaws

Despite the intuitive appeal of Professor Feldstein's argument — which is echoed each day by politicians, journalists, and some market participants — the argument is fatally flawed. Before we comment on these defects, however, we offer a few observations about Professor Feldstein. A professor at Harvard and president of the prestigious National Bureau of Economic Research, Professor Feldstein's qualifications cannot be challenged. However, some of the Professor's major research has, shall we say, been seriously questioned.

For example, a study he published with the late Professor Otto Eckstein showed that the burden of public borrowing falls on investment by raising interest rates, whereas the burden of taxes falls on consumption. Hence Professor Feldstein's championing of tax increases to finance government spending, rather than debt financing. There is only one problem with this conclusion: supply-siders at the US Treasury (namely, Dr. Manuel Johnson, who is now Vice Chairman at the Fed), as well as numerous academics, have failed to generate the same empirical results as the Feldstein-Eckstein study.

Professor Feldstein's major work on social security, when subjected to close scrutiny, also ran into rough waters: One of the key variables in his model was miscalculated, and serious questions have been raised about the Professor's choice of independent variables in his model. The point here is that even academic heavyweights can commit serious technical errors.

Beyond this, we can question Professor Feldstein's judgment. As he often displayed while Chairman of President Reagan's Council of Economic Advisers, the Professor was attracted to the bright lights. As a consequence, he repeatedly undermined the President's tax policies in public. Professor Feldstein displayed once again his lack of judgment with his dollar talk before the American Stock Exchange. It is doubtful that this loose cannon behavior will be rewarded with any post, advisory or otherwise, in the Bush Administration.

Must the dollar fall?

So much for Professor Feldstein. Now let's examine his "the dollar *must* fall" thesis. The first problem with the Professor's argument is that it assumes persistent foreign exchange market irrationality. After all, if the market participants were cognizant of the long-run unsustainability of the US current account deficit, the dollar would fall sharply to a new equilibrium level that was consistent with that information.

Another flaw in the thesis revolves around the fact that the dollar is a reserve currency. The dollar is an accepted means of international payment. This combined with the liquidity available for dollar assets means that there is a large and growing demand for dollar assets as world wealth increases. In addition, as the world financial markets become liberated and integrated, foreign investors are diversifying their portfolios, primarily by acquiring dollar assets. In consequence, until the process of liberalization and integration of financial markets is completed, the ratio of dollar assets to total world wealth will continue to rise. This fact, too, acts to stimulate the demand for dollar assets.

The final flaw in "the dollar *must* fall" thesis is the fact that it assumes that exchange rate adjustments are the sole means of reducing current account "imbalances." For some time, we have argued that the devaluation of the dollar is not an effective means to promote adjustment, because the devaluation is not being fully passed through to import prices. As Chart 6 shows, international competition has kept a lid on import prices. The only means to reduce the current account deficit (the supply of dollar assets) in any meaningful way is to increase US savings and reduce consumption and/or investment.

No Damocles' Sword

The US current account deficit — which has stabilized, if not started to contract, in absolute terms and has begun to shrink relative to GNP — is not the sword of Damocles hanging over the US economy and the dollar. Even though the US continues to pump out a stream of dollar assets, foreigners continue to mop up these assets as foreigners' wealth increases and world financial markets become liberalized and integrated. So long as the US continues to prevent a significant up-tick in inflation, slowly reduces its budget and current account deficits, and refrains from restrictions on foreign trade and foreign investments, there is no reason to believe that the dollar *must* fall. The supply of dollar assets is admittedly high, but so is the foreign demand.

In conclusion, there is no fundamental reason why the dollar *must* fall. However, this is not to say that the dollar won't fall. As we all know, from time to time foreign-exchange traders can lose their shirts trading on long-run fundamentals, as opposed to "market forces" (psychological factors).

– Steve H. Hanke

Chart 6 – PERCENTAGE CHANGE IN EXCHANGE RATES AND RELATIVE PRICES

Time Period	Effective Dollar* Exchange Rate	Ratio of U.S. Import Prices to U.S. GNP Deflator
I/1977 - II/1980	-11.5 %	+ 9.0%
II/1980 - I/1985	+46.3 %	-29.4%
I/1985 - II/1986	-25.6 %	- 0.8%
II/1986 - I/1987	-10.7 %	+ 1.2%
I/1987 - IV/1987	- 7.3 %	+ 1.3%
IV/1987 - II/1988	- 3.67%	+ 1.2%
IV/1987 - III/1988	+ 2.1 %	+ 0.6%

*Effective exchange rate changes are an indicator of the extent to which the external value of a country's currency has moved relative to other currencies. Effective exchange rate changes are computed as an index, combining the exchange rates between the currency in question and 17 other major currencies with weights derived from the International Monetary Fund's "Multilateral Exchange Rate Model." Each weight represents the model's estimate of the effect on the trade balance of the country in question of a change of one percent in the domestic currency price of one of the other currencies. The weights, therefore, take account of the size of trade flows as well as of the relevant price elasticities and the feedback effects of exchange rate changes on domestic costs and prices. The measure is expressed as an index based on average exchange rates during 1980.

CURRENCIES

The EMS drag

The European Monetary System (EMS) began operating in March 1979. All members of the European Economic Community, except Portugal, have signed the EMS agreement. The purpose of the EMS is to foster exchange-rate stability through a "target zone" arrangement. With the exception of Greece, Great Britain, and Spain, all the EMS signatories participate in the EMS's Exchange Rate Mechanism (ERM). The ERM requires participants to maintain their exchange rates within a specific margin around agreed-upon, fixed central rates.

The unit of account for the ERM is the European Currency Unit (ECU). It is a composite currency, consisting of a fixed amount of each of the EMS countries' currencies. The quantity of each country's currency in the ECU reflects that country's relative strength in the European community.

Price ceiling on DM

Based on economic fundamentals, the German mark (DM) is the EMS's superior currency. This fact is shown by reviewing Charts 7 to 9. As can be seen, Germany's economic performance on the domestic front (inflation and real growth) and on the external front (current account) is, indeed, superior to other EMS countries. By being tied into the EMS, the DM has a drag placed on it because the other economies don't, in general, perform as well. The implication is that the DM, if it was allowed to float, would be stronger than it is in the EMS. To put it in other words, the ERM mechanism tends to put a "price ceiling" on the DM.

The price ceiling is most evident when the dollar is "weak." During periods of dollar weakness, we can observe that all EMS currencies appreciate vis à vis the dollar, and that the DM tends to appreciate against other European currencies. Moreover, the DM tends to be at the top of its allowed ERM range during the periods of dollar weakness.

There are other pieces of evidence that suggest that the EMS acts as a drag on its strongest, from a fundamental point of view, currency (DM) when the dollar is weak. Consider the recent behavior of the British pound. In the Spring of 1987, Mr. Nigel Lawson, Chancellor of the Exchequer, took a pro-EMS stance and began a policy of shadowing the DM. This misguided policy was finally brought to a conclusion when, in early 1988, Sir Alan Walters showed Prime Minister Thatcher Britain's exploding monetary base numbers. In consequence, Mr. Lawson's exchange-rate shadowing was stopped and the pound was allowed to float. The pound began to appreciate under the new floating policy. This experience lends some evidence to the thesis that the EMS acts as a drag on a strong DM.

Further evidence of the EMS drag's effect on the DM is shown by the recent appreciation of the yen in relation to the DM. During the dollar's weakness since 1985, both the yen and DM appreciated vis à vis the dollar. However, because of the EMS's drag and price ceiling effect on the DM, the yen appreciated relative to the DM.

What traders should do

The trading implications of the EMS drag are rather straightforward. Under dollar weakness, the DM won't appreciate as rapidly as if it were floating. Hence, for maximum profits, speculators should be long the yen, vis à vis the dollar, not the DM, because the yen will tend to appreciate more rapidly than the DM. This results because the yen is not subjected to the EMS drag. It is important to mention that this trading posture has become more attractive in recent years because the Japanese have continued to liberalize their capital markets. This has made entry into Japan's capital markets easier. Hence, what was a drag on the yen during periods of dollar weakness — restrictions on entry into Japan's capital markets — is being removed.

For those who wish to cross-trade during periods of dollar weakness, a long yen/short DM cross is logical. Again, this result is obtained because of the EMS drag on the DM. However, it is important to mention that this cross-trade will not do as well as an outright long yen vis à vis dollar position.

Now let's turn to the case where the dollar is strong. In this case the EMS drag is lifted from the DM and the price ceiling is no longer relevant because currencies are depreciating vis à vis the dollar. Hence, for maximum profits, speculators should be short the yen vis à vis the dollar. The logic of this position results from the fact that prior to dollar strength, we assume that there has been dollar weakness. On this assumption, the DM, with EMS drag, has not been allowed to appreciate as much as the yen during the dollar's weakness. Hence, once the dollar gains strength, the DM will not have as far to adjust to a new, lower "equilibrium" as the yen will have.

For those who wish to cross-trade during periods of dollar strength, a long DM/short yen cross is logical. *Again, it is important to mention that this cross-trade will not do as well as an outright short yen vis à vis dollar position.*

Before closing, it is interesting to mention that cross traders have become increasingly interested in a long DM/short yen cross-trade. Given our EMS drag analysis, this trade is logical only when the prospect is for a strong dollar. In the strong dollar case, however, it would be more profitable to be short the yen outright vis à vis the dollar, rather than a cross-trade. If this weren't enough, it is our impression that most of the traders who are looking favorably on the long DM/short yen cross-trade expect the dollar to remain weak. If traders believe that the dollar will, indeed, remain weak, they will be crossed-up by the EMS drag because the yen will continue to appreciate vis à vis the DM.

– Steve H. Hanke

Chart 7

CHANGE IN CPI (percentage)

ERM Countries	1979	80	81	82	83	84	85	86	87
Belgium	4.45	6.61	7.60	8.74	7.69	6.35	4.85	1.28	1.55
Denmark	9.61	12.36	11.70	10.11	6.91	6.31	4.72	3.62	4.02
France	10.66	13.38	13.40	11.82	9.62	7.41	5.76	2.53	3.34
Ireland	13.25	18.20	20.40	17.11	10.50	8.60	5.44	3.81	3.13
Italy	14.74	21.21	17.80	16.47	14.65	10.81	9.18	5.85	4.75
Netherlands	4.22	6.50	6.70	5.90	2.83	3.27	2.25	0.10	-0.73
FRG	4.17	5.37	6.30	5.27	3.31	2.42	2.20	-0.25	0.25
ERM Average*	8.78	11.88	11.39	8.08	8.14	6.23	5.11	2.25	2.32
ERM Average excluding FRG**	11.13	15.21	13.97	12.74	10.62	8.18	6.61	3.53	3.39
Non-ERM Countries									
Japan	3.58	7.99	4.90	2.76	1.95	2.18	2.05	0.61	0.09
U.S.	8.48	8.58	9.90	6.37	3.93	4.30	3.49	1.99	3.61
Switzerland	3.05	4.06	6.50	5.63	3.02	2.93	3.44	0.72	1.45
U.K.	13.52	17.92	11.90	8.58	4.61	5.04	6.07	3.39	4.17
Canada	9.01	10.25	12.40	10.85	5.78	4.32	4.00	4.13	4.37

*: Weighted by Percentage of Nominal GNP in Total ERM GNP
**: Weighted by Percentage of Nominal GNP in Total ERM GNP, excluding FRG

Source: IMF, International Financial Statistics

Chart 8

CURRENT ACCOUNT/NOMINAL GDP (percentage)

	1979	80	81	82	83	84	85	86	87
ERM Countries									
Belgium	-2.77	-4.12	-4.26	-3.02	-0.52	-0.07	0.08	2.61	2.08
Denmark	-4.50	-3.72	-3.28	-4.05	-2.10	-3.02	-4.78	-5.18	-2.93
France	0.90	-0.64	-0.84	-2.23	-1.00	-0.18	0.01	0.41	-0.58
Ireland	-54.31	-46.87	-37.18	-20.43	-10.25	-6.16	-4.16	-4.96	3.01
Italy	1.67	-2.48	-2.44	-1.63	0.16	-0.82	-0.83	0.48	-0.14
Netherlands	-1.31	-1.76	2.06	2.68	2.91	4.12	4.31	2.50	1.47
FRG	-0.81	-1.96	-0.74	0.60	0.82	1.58	2.73	4.46	4.06
ERM Average*	-0.15	-2.03	-1.37	-0.95	0.12	0.44	0.88	1.85	1.30
ERM Average excluding FRG**	0.30	-1.98	-1.63	-1.69	-0.22	-0.14	-0.06	0.52	-0.13
Non-ERM Countries									
Japan	-0.87	-1.01	0.41	0.63	1.76	2.79	3.71	4.38	3.65@
U.S.	-0.04	0.07	0.21	-0.26	-1.40	-2.86	-2.98	-3.31	-3.42
Switzerland	1.33	-1.53	1.59	4.08	1.23	4.41	8.15	3.44	n/a
U.K.	-1.52	7.55	10.45	4.36	2.39	0.83	1.98	-0.20	-1.71
Canada	-1.78	-0.36	-1.72	0.70	0.42	0.56	-0.56	-2.07	-1.93

*: Weighted by Percentage of Nominal GNP in Total ERM GNP
**: Weighted by Percentage of Nominal GNP in Total ERM GNP, excluding FRG
@: GNP used; GDP unavailable
n/a: both GNP and GDP unavailable

Source: IMF, International Financial Statistics

Chart 9

CHANGE IN REAL GNP (percentage)

	1979	80	81	82	83	84	85	86	87
ERM Countries									
Belgium@	1.63	3.27	-1.54	1.12	0.00	1.50	0.93	2.70	1.76
Denmark@	3.43	-0.44	-0.90	2.93	2.07	3.42	2.61	3.23	-1.06
France@	3.20	1.04	0.46	1.77	0.73	1.50	1.27	2.04	2.21
Ireland@	2.98	2.99	2.50	0.80	-0.04	4.22	1.60	-0.36	3.90
Italy@	4.67	3.76	0.17	-0.52	-0.42	2.50	2.76	2.75	3.01
Netherlands	0.81	-0.73	-1.74	1.28	1.63	1.97	2.71	1.71	2.43
FRG	3.81	1.45	0.01	-0.97	1.51	2.94	2.35	2.40	1.65
ERM Average*	3.56	1.81	-0.03	0.23	0.80	2.34	2.13	2.38	2.13
ERM Average excluding FRG**	3.43	1.99	-0.05	0.85	0.39	2.02	2.02	2.36	2.36
Non-ERM Countries									
Japan	5.02	4.21	3.44	2.99	3.14	4.82	4.44	2.43	4.20
U.S.	2.42	-0.16	1.89	-2.61	3.41	6.14	2.19	3.45	2.81
Switzerland@	2.40	4.40	1.45	-1.11	0.64	1.99	3.09	2.67	n/a
U.K.@	2.18	-2.36	-1.24	1.23	3.48	1.95	2.92	2.85@	3.52@
Canada	3.08	1.07	3.19	-4.64	3.19	4.45	4.63	3.07@	3.87@

*: Weighted by Percentage of Nominal GNP in Total ERM GNP
**: Weighted by Percentage of Nominal GNP in Toyal ERM GNP, excluding FRG
@: Real GNP unavailable; Real GDP used
n/a: Both Real GNP and Real GDP unavailable

Source: IMF, International Financial Statistics

GOLD

New lows on the way

The extremely weak US dollar panicked gold bears, helping to extend the rally in gold prices in time (four weeks) and in price (approximately $15/oz.). In fact, the most recent high in open interest was recorded on October 25 at 165,718 contracts, with nearby prices closing at just under $410/oz. By the close of November 15, open interest had declined to 148,897 contracts, and coincidentally, the price had risen to a new recovery high of $425.60, basis nearby December.

Thanks to its semi-monetary role, or at least its perception as such, gold prices rose while other commodity prices fell, affecting adversely our two bear spreads, long CRB futures/short gold and long silver/short gold. The argument behind these two spreads is relatively simple: Gold prices are high in real terms and as a result have unleashed a major expansion of output (see *FC&CC* September 11: "The chickens are coming home to roost"). *Real* gold prices therefore must drop in the face of heavy supplies. Either commodity prices rise faster than gold (or drop more slowly) or nominal gold prices fall while commodity prices remain unchanged or rise. Either way, CRB futures are likely to outperform gold in the medium term. At the same time, silver's output, primarily a by-product of copper and zinc, has not experienced nearly as spectacular an increase. This divergence in production trends and marginal costs of production should operate to lower the gold/silver ratio from its near historic high of 69/1.

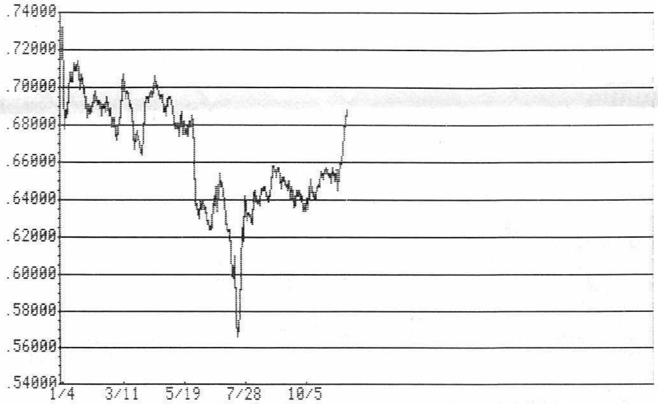
STRATEGY: *The bounce in gold prices that we had anticipated in September starting from a low of $394/oz. has come to an end. Over the next few weeks and months, gold is likely to be reaching new lows, breaking the $394/oz. level and perhaps finding support in the $350-$360/oz. area.*

As soon as the dollar-bashing eases, our spreads will improve. In the interim, roll forward the long 2 December '88 CRB/short 7 December '88 gold spread to March '89 and April '89 respectively. Leave stops at .540 (see Chart 11), close only.

Chart 10 – COMEX GOLD DEC 88

Chart 11 – CRB/GOLD

Chart 12 – CRB/SILVER



STOCKS & T-BONDS

A double-whammy spread

The enormous increase in corporate leverage is turning common stocks into subordinated junk bonds. Consequently, their yields have to rise and their earnings multiples have to shrink. That is the first reason why price-earnings ratios have been declining for the past 12 months.

The arithmetic runs as follows: medium-grade, long-term industrial bonds yield roughly 11.4%. Leveraged corporate America—on the average—should yield no better than medium-grade bonds. But equities are junior securities to bonds. Ergo, they must yield *something* above 11.4% (12%, 12.5%?). P-E ratios, therefore, must fall to 8 to 8.5. *Given* the latest 12-month Dow Jones Industrial earnings of $168.54, an 8 multiple translates into 1,348 level, a 35% implicit drop. The same is true for the S&P 500 (earnings $21.70, level 173.60, a 35% drop).

That is, *if earnings don't crumble*. But, of course, once earnings decline, p-e ratios rise to anticipate the inevitable earnings recovery. The critical earnings figure on which to apply the multiple is the anticipated earnings level. The 1974-75 historical precedent indicates a possible 25% drop in corporate earnings. A recent Merrill Lynch study confirms this possibility, given the corporate sector's extreme leverage.

Let us now return to our exercise. Assume a 25% drop in Down Jones Industrial earnings and in S&P 500 earnings. Apply multiple of 8 to these adjusted earnings. What do you get? A Dow Jones at *1,011* and an S&P at *130*.

These projections are almost exactly in line with our earlier estimates of the path of the bear market (see particularly *FC&CC* issues of Feb. 21 and April 25), even though we used a different methodology.

What if interest rates tumble? The question is, of course, which interest rates? Treasury long-term rates don't matter, as we saw. What matters is corporate interest rates. Our guess is that the medium grades/Treasury spread will widen sufficiently into the next recession as to make little difference to the equity model valuation. Just in case, however, why not buy Treasury bonds and sell S&P 500 futures in equal face value amounts?

In the best case, a deflation may lower Treasury interest rates with little or no impact on medium-grade bonds. The profits in the spread could be enormous (S&P 500 at 130, T-bonds at 100 or even 120). In the worst case, interest rates go down across the board, and the profit on the spread is merely the S&P 500 adjustment to a higher differential yield. Still nicely profitable. A no-lose spread, or so we think.

STRATEGY: *Remain short Value Line/long S&P 500. It is working out. Remain long March '89 270.00 strike puts, acquired at very good prices, as per FC&CC of Sept. 18.*

New recommendation: Buy 3 March '89 T-bonds/sell 2 March '89 S&P 500 (see Chart 14).

Chart 13 – CME S&P 500 INDEX

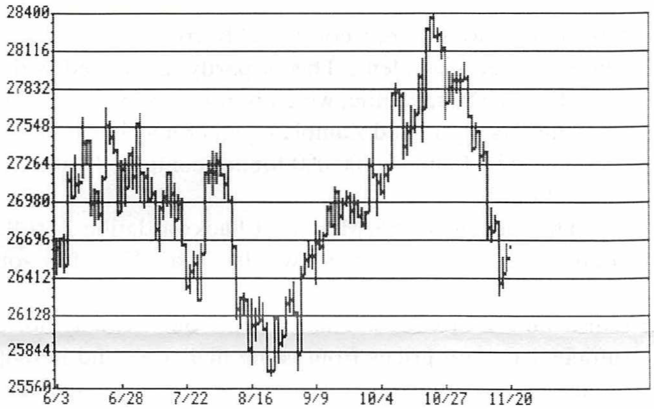
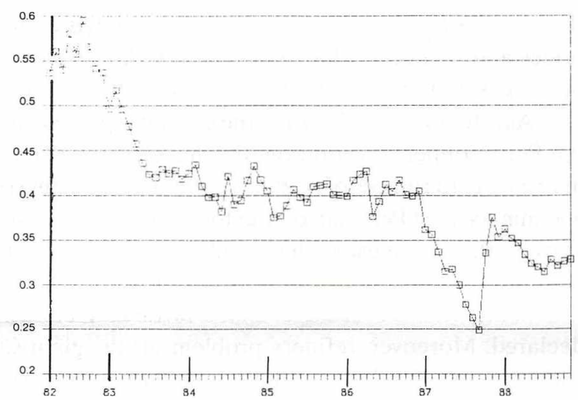


Chart 14 – U.S. TR. BONDS/S&P



CRUDE OIL

Stay heavily short!

Crude oil is in a well-defined downtrend (see Chart 15). The market is awaiting the outcome of Opec talks, but a bullish outcome is highly unlikely. The Saudis need revenue desperately and will not cut back soaring production unless *everyone* is back to earlier quotas — a very unlikely possibility.

If an agreement is reached, it is more likely to be around 19-20 million barrels per day and around a $15 benchmark. In that event, free market prices will continue a long, drawn-out decline. *If no agreement is reached*, the revenue maximizers (see our last issue) will at least initially cause the price to drop below $5/barrel.

STRATEGY: *Stay heavily short.*

Chart 15 – NYME CRUDE LIGHT JAN 89

THE EXOTICS

Saudi riyal

The moment of truth is at hand. A run against the Saudi riyal is gaining momentum (and adherents) despite Finance Ministry denials. A devaluation is imminent.

STRATEGY: *Add to one-year short positions. The discount is less than ¾ of 1% annually, a giveaway. We look for a minimum 10% devaluation. A maxi or a float could see the riyal 30% lower.*

COPPER

On the rise again

Refusing to join in the weakness of associated commodity prices and fuelled by drawdowns in warehouse stocks, copper prices shot up past $1.50/lb., their highest level in history.

As attention was drawn to the continuing strike at Southern Peru Copper Corporation, the market ebbed and flowed in response to rumors of settlement between the government and miners. Lost Peruvian output for the year is now estimated at over 80,000 tonnes. With no real settlement in sight as the country is engulfed in political chaos and hyperinflation, the probability looms ever larger that a force majeure would be declared. Moreover, refinery problems at the giant Chuquicamata mine in Chile is adding concern to an extremely nervous market.

Last year, an extremely wide backwardation attracted metal into the warehouse, but as we pointed out in a number of articles, it helped only to redistribute copper and postpone consumption that's not critically needed. It neither created new supplies nor diminished near-term demand. Our argument has basically been that backwardation helps buy time for a market undergoing severe supply "shortages" or bottlenecks. The presumption is that *given time* supplies will increase (attracted by fatter profits), demand will drop off (substitution, conservation), and the "shortages" will disappear.

It has not happened with copper... yet. World demand continues strong, and new supply problems have appeared. Aside from the already-mentioned Peruvian strike, African production has suffered considerably from the exodus of white engineering talent. This is partly associated with a spreading AIDS epidemic, which is also causing havoc with black miners. Zaire and Zambia together may see an output drop in 1988 of almost 100,000 tonnes compared with 1987 production.

The December 88/March 89 backwardation of 1,920 points is already wider than it was last year. Therefore, one can expect some "relief" in the way of postponement and redistribution of stocks. This "relief" however, may not be sufficient to stop prices from going higher — and perhaps dramatically so. Since supply, in the *near term* is quite inelastic (Peru, Zambia, Zaire), the entire burden of the adjustment will have to fall on consumption. To affect the latter, prices may have to move into the $1.75-$2.00/lb. area. This forecast takes into account the fact that *real* copper prices remain today substantially lower than they were during the '60s and '70s.

STRATEGY: *Reenter long side of market via the purchase of March '89 contracts. Stops should be placed just below this week's low 107.60, close only. Less courageous traders may wish to purchase March 120 strike call options, trading at around 8½-9.00¢/lb. With a breakeven of $1.29/lb. ($1.20 strike and 9¢ premium), these calls represent good value in view of cash Comex prices of $1.42/lb.*

Chart 16 – COMEX COPPER DEC 88

SUGAR

The flight is getting fragile

This market is making a valiant attempt to fight the force of (commodity) gravity. A clean breakout above 10.50, basis March '89, would signal a dramatic bull run. On the other hand, a close below 9.70 would "ruin" the promising flag formation, indicating lower prices ahead.

It is getting increasingly difficult to find a good long position.

STRATEGY: *Raise protective stops to 9.70, basis March '89, close only.*

Chart 17 – N.Y. #11 SUGAR MAR 89

POTPOURRI

Bits and pieces from wheat to Sterling

Poor technical action has forced us to abandon the long wheat position; remain sidelined.... Bright live cattle fundamentals fighting a bearish deflationary trend; retain 71.75 stop, basis February '89, close only.... Remain long November '89 soybean and March '89 soymeal; maintain stops of $6.60/bu. and $219/ton respectively, close only.... Our short position in March '89 90-day Sterling interest rate deposit is paying off handsomely; lower stops to 88.50, close only.

FRIEDBERG CAPITAL MARKETS

Recommended bond portfolio allocation:

New Zealand dollar bonds	40%
US dollar floaters	60%

Chart 19
Foreign currency bond investment yearly performance Oct. 31/87 - Oct. 31/88 For a US$ Based Investor

Had you invested on Oct. 31/87 in:	% appreciation/ depreciation due to currency fluctuation	% appreciation/ depreciation due to price of bond interest rate fluctuation X currency appreciation	Nominal Coupon X currency appreciation	Total Return in US$ *
Wells Fargo 16⅛% 5/12/89 NZ$	+ 5.21	+6.65	+16.97	28.83%
Quebec Hydro 5½% 1/5/96 DM	- 2.98	+3.51	+ 5.34	5.87%
Canada 5⅝% 23/7/93 JY	+10.42	+2.03	+ 6.21	18.66%
Australia 5% 30/10/98 SF	- 4.93	+2.02	+ 4.75	1.84%
C.I.B.C. 13% 13/3/91 A$	+22.48	+2.72	+15.92	41.12%

*Assumes that all coupons were reinvested fully.

Chart 18
FOREIGN CURRENCY BONDS

Date: November 17, 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 1/2 -	105 1/4	13.30	02/04/88-02/04/89
BANK OF NOVA SCOTIA 15/09/89 18 1/2% **RRSP eligible**	103 -	103 3/4	13.07	15/09/88-15/09/89
WELLS FARGO (semi annual) 12/05/89 16 1/8%	100 3/8 -	101 1/8	13.98	12/05/88-12/11/88
EASTMAN KODAK (semi annual) 15/02/89 17%	100 1/4 -	101	12.44	15/08/88-15/02/89
MCDONALD'S (semi annual) 15/08/90 16 3/4%	105 1/4 -	106	13.13	15/08/88-15/02/89
TOURIST HOTEL (N.Z.) 04/06/93 zero coupon	52 1/8 -	53 5/8	14.76	matures 04/06/93
AUSTRALIAN DOLLAR DENOMINATED BONDS				
COMMONWEALTH BANK OF AUSTRALIA 01/07/94 14%	102 1/4 -	103	13.16	01/07/88-01/07/89
WORLD BANK 15/03/93 12 3/4% **RRSP eligible**	99 1/2 -	100 1/4	12.62	15/03/88-15/03/89
CAN.IMP.BANK OF COMMERCE 13/03/91 13% **RRSP eligible**	97 -	98	13.98	13/03/88-13/03/89
DANISH KRONE DENOMINATED BONDS				
WORLD BANK 20/11/92 9 3/4% **RRSP eligible**	100 1/2 -	101 1/4	9.36	20/11/87-20/11/88
STOCKHOLM 10/11/91 10 5/8%	103 5/8 -	104 3/8	8.87	10/11/88-10/11/89
DEUTSCHE MARK DENOMINATED BONDS				
QUEBEC HYDRO 1/5/96 5 1/2 **RRSP eligible**	97 1/4 -	98	5.83	01/05/88-01/05/89
SWISS FRANC DENOMINATED BONDS				
GOVT.OF AUSTRALIA 30/10/98 5%	103 1/4 -	104	4.49	30/10/88-30/10/89
JAPANESE YEN DENOMINATED BONDS				
GOVT.OF CANADA 23/7/93 5 5/8% **RRSP eligible**	104 -	104 3/4	4.47	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)	99.96	-100.26	8 1/16%	24/09/88-28/12/88
REPUBLIC OF ITALY	**30/4/93**	**3 mo Limean (quarterly)**	98.70	- 99.10	8 5/8%	31/10/88-31/01/89

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

ISSUER	MAT.DATE/COUPON	BID	OFFER	CUR.COUP.	**Int.Rate of Return	
BANCO CENTRAL (restructured) De CHILE	12mo.LIBOR +1 1/8 (annually)	57	-60	9.0625	* 15.1%	20/01/88-20/01/89
ARGENTINA BONEX ser.82	15/2/92 LIBOR (sem.ann.)	.8640	-.8750	8 9/16%	** 18.5%	15/08/88-15/02/89 ammortized: 12½% of principal paid yearly

*Simple yield

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

Chart 20
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 NOVEMBER 17/88.**

	U.S. $	NEW ZEALAND $	AUSTRALIAN $	DEUTSCHEMARK	SWISS FRANC	JAPANESE YEN	DANISH KRONE
1 year	8.55%	Wells Fargo 16⅛ 12/5/89 Yields 13.98% (61.8 NZ/US)					
2 year	8.74%	McDonalds 16¾% 15/8/90 yields 13.13% (60 NZ/US)					
4 year	8.89%		World Bank 12¾ 15/3/93 yields 12.62% (74.7 A/US)				World Bank 9¾ 20/11/92 yields 9.36% (6.84 Dkr/US)
5 year	8.87%	Tourist Hotel 0% 4/6/93 yields 14.76% (49.9 NZ/US)				Gov't of Canada 5⅝% 23/7/93 yields 4.47% (100.0 JY/US)	
6 year			Com. Bk. of Aus. 14% 1/7/94 yields 13.16% (68.1 A/US)				
8 year				Quebec Hydro 5½ 1/5/96 yields 5.83% (137.62 US/DM)			
10 year					Australia 5% 30/10/98 yields 4.49% (95.5 US/SF)		
Spot Exchange Rate	N/A	.6475	.8577	1.735	1.4565	122.95	6.7075

**For example, in parentheses, since a US$ based investor would receive 543 basis points (1398-855) by holding the Wells Fargo NZ$ bond, NZ$ can depreciate to .618 NZ/US from the present spot exchange rate of .6475 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.

FOREX RATES & UPDATE

Currency	*Spot*	*3-Month*	*12-Month*	*Comments vis à vis DM*	*Comments vis à vis DM (Spot DM: 1.7370)*
Australian dollar	.8550-.8570	.8426-.8450	.8117-.8143	Neutral	Neutral
Belgian franc	36.42-36.45	36.22-36.29	35.66-35.84	Neutral	Neutral
Danish krone	6.6980-6.7030	6.6810-6.6910	6.6455-6.6675	Neutral	Neutral
Dutch guilder	1.9600-1.9615	1.9415-1.9435	1.8910-1.8940	Neutral	Neutral
Greek drachma	144.50-144.60	148.10-150.40	154.80-163.90	Remain short	Remain short
Hong Kong dollar	7.8050-7.8060	7.7765-7.7795	7.7200-7.7760	Neutral	Neutral
Irish punt	1.5300-1.5315	1.5332-1.5357	1.5380-1.5415	Neutral	Neutral
Italian lira	1293-1294	1301-1303	1320-1326	Neutral	Remain short
Kuwaiti dinar	.27980-.28010	.27780-.27850	.27320-.27420	Remain short	Neutral
Malaysian ringgit	2.6780-2.6790	2.7080-2.7120	2.7750-2.7800	Neutral	Neutral
New Zealand dollar	.6470-.6480	.6382-.6407	.6140-.6200	Remain long	Neutral
Norwegian krone	6.5940-6.5990	6.6785-6.6855	6.8125-6.8425	Neutral	Neutral
Portugese escudo	144.40-144.90	145.65-146.90	150.40-153.50	Neutral	Remain long
Saudi Arabian riyal	3.7500-3.7510	3.7535-3.7565	3.7600-3.7660	Remain short	Remain short
Singapore dollar	1.9480-1.9490	1.9300-1.9330	1.8945-1.9025	Neutral	Neutral
Spanish pesetas	114.70-114.80	115.60-115.80	118.30-118.80	Remain short	Neutral
Swedish krona	6.0610-6.0660	6.0835-6.0910	6.1360-6.1560	Remain short	Neutral

Explanatory Notes

*Indicates change in recommendation from last issue.

Currency expected to firm against both currencies.	Buy	Buy
Currency expected to strengthen against US$ and weaken against DM.	Buy	Sell
Currency expected to weaken against both major currencies.	Sell	Sell
Currency expected to weaken against US$, but strengthen against DM.	Sell	Buy
Term used to liquidate short position but does not imply a new buy recommendation.	Cover	
Term used to indicate sale advice of previous long position, but does not imply a new short sale recommendation.	Liquidate	

HOTLINE UPDATE

Tuesday, October 25: No changes or new recommendations. The market letter is in the mail.

Friday, October 28: No changes or new recommendations.

Flash update, Tuesday, November 1, 1:00 p.m.: Reinstate long positions in March wheat, placing stops at 403, good anytime.

Flash update, Tuesday, November 1, 1:20 p.m.: As advised at 1:00 p.m., reinstate long positions in March wheat. Place sell stops at 409, good anytime, repeat *409,* not at 403 as erroneously stated in the previous flash update.

Flash update, Wednesday, November 2, 4:45 p.m.: Raise exposure in NZ bonds to 40% of bond portfolio, not paying over .64 NZ/US for the NZ currency. One note: We reinstated long March wheat positions as of yesterday's flash with stops at 409, good anytime.

Flash update, Friday, November 4, 10:45 a.m.: Reinstate immediately short positions in Japanese yen, SF, DM, and other EMS currencies at market, risking 8191, basis March, for the yen and 5735, basis March, for the DM, good anytime. Follow DM stop for SF and other EMS currencies.

Friday, November 4: A recap of the week's activities:

1. On Tuesday's flash we recommended reinstating long March wheat positions, placing sell stops at 409, good anytime.
2. On Wednesday's flash we recommend increasing NZ exposure to 40% of bond portfolio, not paying over .64 NZ/US for the NZ currencies.
3. This morning we recommended reinstating short positions in JY, SF, DM, and other EMS currencies at market, risking 8191, basis March, for the yen, and 5735, basis March, for the DM, good anytime. Follow DM stop for SF and other EMS currencies.

Wednesday, November 9: There are no changes or new recommendations.

Friday, November 11: There are no changes or new recommendations.

Flash update, Wednesday, November 16, 10:45 a.m.: Liquidate long wheat positions at market and remain sidelined.

Friday, November 18: One change only: As of Wednesday's flash, we have liquidated long wheat positions and are sidelined. The market letter will be mailed Tuesday 22nd.

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