FRIEDBERG'S
COMMODITY & CURRENCY COMMENTS

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The comeback of the greenback

The dollar's path of least resistance is clearly up. Short of a new barrage of dollar bashing, that is.

Gorbachev's offer to thin out his European forces, by itself a minor concession, got the Johnny-come-late crowd of dollar-bears panicky in visions of major Pentagon spending reductions. While the visions are most certainly exaggerated, the reaction revealed a great deal of the market's inner technical condition.

As we stated last month "...the trend is down. As more and more bears join the trend — for the mere sake of following the trend — the market becomes increasingly vulnerable to a reversal." At the time, we posited that the moment would come when the bearish consensus was nearly universal.

The consensus statistics never *did* confirm the depth of pessimism, but the oversized reaction to an almost inane statement made by a desperately short-of-money Soviet leader (what else can you say about offering reductions without a quid pro quo?) does show that there were very few bears left: All those who wanted to be short had already sold.

The second encouraging sign came on the market's reaction to poor news: The trade deficit for October was expected to have narrowed to less than $10 billion, possibly as low as $9 billion. Instead, it shrank to only $10.35 billion. What is worse, exports fell 1.1% from September, raising fears that the 1987-88 improvement was coming to an end (at one point, exports in 1988 were running 30% above the year earlier).

The market shrugged off the news by selling dollars in a most delicate manner and for just *one* day. The very next day, the US dollar climbed to a fresh five-week high. Need the market say more?

We'd like to emphasize three observations we made in the past few months.

(1) The trade deficit has become irrelevant. One hundred twenty billion, or even $150 billion today is no longer what it was in 1986 or 1985, at least in terms of GNP. Clearly, it is *shrinking*.

(2) At any rate, the trade deficit (and its concomitant current account deficit) is the other side of the coin of a *capital surplus*. Foreigners *love* to invest in the US money, capital, and real estate markets. The US is highly competitive in financial and real assets and much less so in goods and services. Do they care? *Should* they care? (For an interesting and enlightening aspect of the driving force behind capital flows, see Dr. Hanke's article, which follows.)

(3) The Louvre Accord and the subsequent additions have *probably* left us with a semi-fixed exchange regime. The tools employed to keep the dollar inside a ¥120-137 and a DM1.70-1.95 range are threefold: words ("the dollar is about right" or "the dollar, at these levels, may lose its competitiveness"); intervention (by the Bundesbank and the Bank of Japan, and more recently and surprisingly, by the Fed, in a big way); and some interest rate coordination.

The next dollar trip should take it to the top of its trading range (¥137, DM1.95). At that point, words and intervention will be used to tame the advance. Some day, however, the US dollar will break out of the range...and it will be on the upside.

STRATEGY: *We are long, as per Hotline Flash Update of Dec. 13, US dollars via sales of Japanese yen, DM, Swiss francs, and other EMS currencies. Place stops at 83.05, 70.27, 58.78, basis March '89 IMM yen, March '89 IMM SF, and March '89 IMM DM respectively, close only.*

In this issue

Season's greetings to all our readers and a healthy and prosperous 1989.

Chart 1 – CME JAPANESE YEN MAR 89

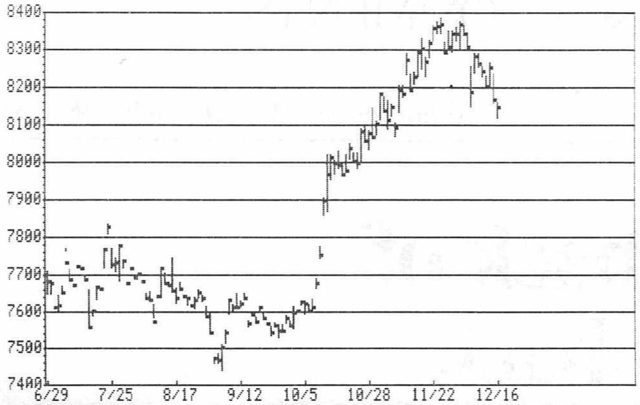


Chart 2 – CME DEUTSCHE MARK MAR 89

Chart 3 – CME SWISS FRANC MAR 89

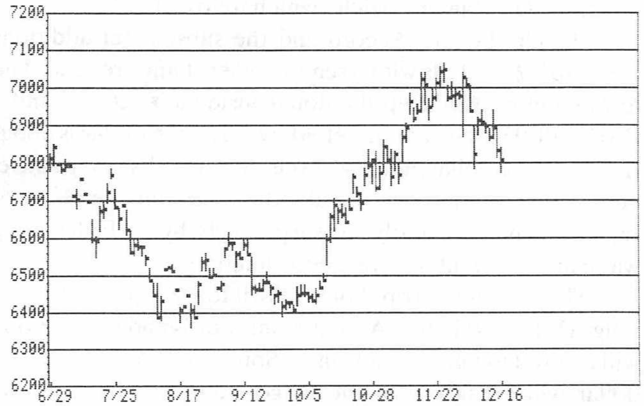
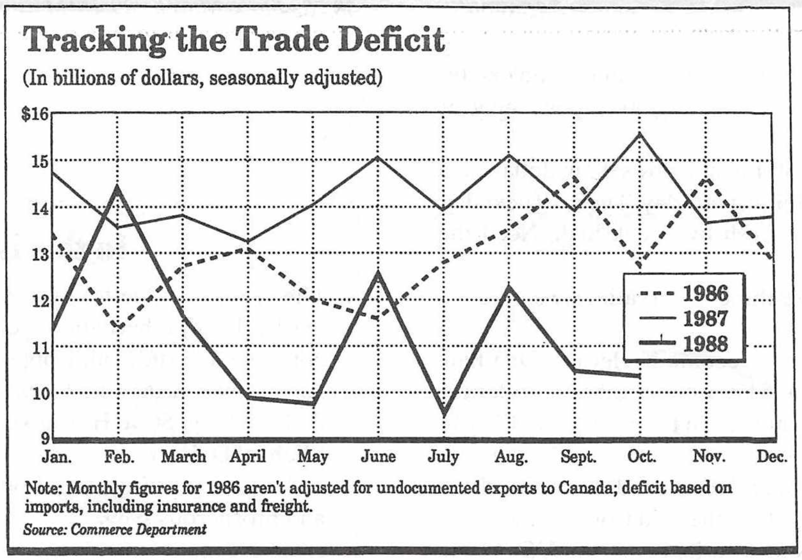


Chart 4 – CME BRITISH POUND MAR 89

Chart 5



Source: *Wall Street Journal*

The search for the FX grail

The sage of Baltimore, H.L. Mencken, once wrote: "As for foreign exchange, it is almost as romantic as young love, and quite as resistant to formulae." After watching exchange rate movements in the 1980s and examining economists' attempts to model them, we are forced to conclude that Mr. Mencken made a most prescient observation.

There are a wide variety of classical foreign exchange-rate (FX) models available. These models are based on various configurations of economic fundamentals. The validity of a model should be empirically verifiable. During the 1980s, the classical FX models have not been confirmed with even a modest degree of consistency. In consequence, they have not displayed a credible degree of explanatory and predictive power vis à vis actual exchange rate behavior.

We argue that the models failed because they are, from a theoretical point of view, misspecified. In other words, the models exclude some important fundamentals. In short, the dismal performance of the classical FX models shows that their builders have only a limited understanding of the process by which exchange rates in the 1980s have been determined.

The first leg: '80 to '82

The unsatisfactory performance of the FX models didn't show up until mid-1982. From mid-1980 to mid-1982, a number of FX models (theories) performed tolerably well. During this period of the dollar's sustained rise, the main determinants of the dollar's exchange value moved, more or less, simultaneously in the "right" direction. That is to say, they moved in a direction that suggested a stronger dollar.

For example, anticipated inflation in the US was falling in relation to the rates expected in other industrial counties. Both US long-term and short-term real and nominal interest rates rose in relation to those abroad. The US current account was strong while current accounts in other large industrial countries, except the United Kingdom, were deteriorating. Although there were professional disagreements, the consensus of the modelers agreed that the first leg of the dollar's long climb was caused by the US tight-money, easy-fiscal policy mix.

The second leg: '82 to '84

The second leg of the big dollar move (mid-1982 to mid-1984) has been referred to by our good friend Dr. Jacob S. Dreyer as the "sparkling bubbles" phase. The dollar's appreciation in this phase can't be convincingly explained by changes in the fundamentals contained in the classical FX models. In fact, the fundamentals started to move in the "wrong" direction. That is, they suggested a weaker, not stronger, dollar. US nominal, short-term interest rates fell sharply as the Fed abandoned the targeting of monetary aggregates. The differences between real, short-term interest rates in the US and those abroad shrank to zero and turned negative. The long-term interest rate differentials between the US and abroad shrank. The US current account turned negative in 1982 while those in Japan and Europe began to improve.

The poor performance of the classical FX models during this period set the modelers to work on new models. One type of model that became the focus of a good bit of attention was called the rational bubble model. According to this type of model, the dollar was driven upward by rational speculation rather than by the fundamentals.

In a rational speculative bubble, the bidding for the dollar is caused by expectations of an accelerating rate of dollar appreciation. Rational market participants are aware that the dollar is moving against the fundamentals, that the exchange rate is on an explosive path, and that the bubble must eventually burst. However, even though the probability of the bubble's eventual burst is one, the probability that it will burst in the next week or month immediately ahead is relatively small. In consequence, many rational speculators choose to continue to remain in the market. According to this model, a rational bubble will burst when the probability of collapse in the near term becomes so great that the expected rate of appreciation in the event of no collapse is not great enough to compensate for the possibility of a bursting bubble and a large capital loss. At this point, the speculators will pull the plug on their long positions, the bubble will burst and the dollar will move back to a level that is in line with its fundamentals.

The rational, speculative bubble literature, although it has generated a good bit of academic interest, is not too helpful. After all, the rational bubble models don't offer much in the way of useful predictions about when a bubble will break.

Irrational bubbles

The continued rise of the dollar from mid-1984 is particularly noteworthy in light of the changes in the alleged fundamentals. US economic growth slowed. US short-term interest rates fell. Long-term, inflation-adjusted interest rates, which favored the dollar, kept shrinking. And the US trade deficit began to explode. These factors threw even the rational bubble models into question. After all, the rational bubbles are based on a rational calculus of risks and rewards.

But with the continued rise in the dollar's value, the rational calculus became increasingly suspect. In consequence, the modelers went into what can best be termed mystifying bubbles. With the abandonment of the rationality assumption, the modelers began to contemplate irrational bubbles. This effort didn't bear fruit. Indeed, the notion that market participants were irrational turned out to be a theoretical non-starter. The irrational bubble theory can rationalize virtually everything and be contradicted by virtually nothing.

When the bubble broke

The "bubble," if it was one, finally broke in March 1985. This validated the bubble models axiomatically, which isn't very helpful. More to the point, since the dollar's decline had been widely expected for some time, it was easy to explain with the old fundamentals. But this too isn't very helpful.

Even through the dollar's decline since March 1985 can ostensibly be viewed as a reaffirmation of the classical FX models, this doesn't wipe out their previous record of failure. Moreover, the drubbing that the dollar took after Mr. George Bush was elected President in November 1988 can't be explained by viewing the dollar's fundamentals. After all, the fundamentals suggest that the dollar's move up since mid-1988 was justified and that it would continue. The classical models are missing something. Let's review the 1980s again in an attempt to find the missing pieces to the FX puzzle.

The missing FX piece

The missing piece of the FX puzzle is supply-side economics. Specifically, tax policy is absent from the classical FX models. US tax policy changes have not only been large during the 1980s but they also explain, in a consistent manner, major changes in the dollar's course.

When President Reagan was elected in 1980, he received a mandate to implement supply-side economics. The cornerstone of this brand of economics was put into place with the signing of the Economic Recovery Tax Act (ERTA) in August 1981. ERTA, which was anticipated in 1980, legislated sweeping changes in both the individual and corporate tax systems. Of particular interest is the corporate side of the ledger. Responding to concern about insufficient capital formation, ERTA allowed for accelerated depreciation of new capital assets and a system of expanded tax credits for new capital investments. In consequence, ERTA greatly increased the after-tax rates of return on new capital and motivated the start of an investment boom. This ultimately increased stock of US capital, productivity, and competitiveness.

It should be noted that the Tax Equity and Fiscal Responsibility Act (TFRA) of 1982 took back some of the tax reductions granted to businesses under ERTA. For example, TFRA reduced the tax benefits generated by the investment tax credit and accelerated depreciation, so that they would not be more generous than an immediate investment writeoff. Even after TFRA, however, the effective tax rates on new capital remained much lower than they had been before ERTA.

Foreign investments reduced

The question is: What did these supply-side tax changes have to do with the exchange rates? By increasing after-tax rates of return on new capital, the supply-side changes increased the desired stock of business fixed investment by about $200 billion above the levels desired without the 1981 and 1982 tax acts. In consequence, to take advantage of domestic opportunities, US investors reduced their foreign investments from what they would have been. This reduced the supply of dollars on foreign exchange markets from what it would have been.

In addition, foreign capital flowed into the US to take advantage of relatively high US rates of return on new investments. Hence, the demand for dollars was higher than it would have been if the new tax policies had not been adopted. The bottom line was that a large net capital flow moved into US investments, and this led to an increase in the value of the dollar throughout the mid-1980 to mid-1985 period.

Conventional wisdom

As we have already mentioned, the classical FX models didn't work well over the entire mid-1980 to mid-1985 period. At this point, it is worth mentioning a few more details about the conventional wisdom regarding the dollar's run up, because by doing so, we will illustrate just how dominant the supply-side tax changes were.

The most conventional interpretation — which is championed by Prof. Martin Feldstein and echoed by the journalists, politicians, and market commentators — is that the increase in the federal deficit increased real interest rates, and that these higher rates increased the dollar's exchange rate.

Several comments are in order. Even using the most sophisticated statistical techniques, researchers have, by controlling for other factors that affect interest rates, found it difficult to estimate any significant effects of the deficit on interest rates. Studies have also concluded that in any case, there is no simple relation between interest rates and exchange rates. Not surprisingly, no consistent relation between budget deficits and exchange rates over time and across nations can be found.

To drive the problem with the conventional wisdom home, consider that if real interest rates were high primarily because of the increased federal deficit, real domestic investment in the US would have been unusually weak. In fact, real domestic investment increased at a higher rate in 1983 and 1984 than during a typical economic recovery. Contrary to the conventional wisdom, the increase in the US real interest rates was primarily due to an increase in the demand for domestic investment, which was, in turn, caused by the business investment incentives contained in the supply-side tax reforms.

Supply-side explanation

The supply-side analytics are useful to consistently explain not only the mid-1980 to mid-1985 rise in the dollar but also its fall from favor, which started in March 1985. In late November 1984, the US Treasury released a draft of a new tax reform package. Then, in May 1985, President Reagan's proposed tax reforms were released. The major features of the House tax bill were revealed in September 1985 and approved in December. The Senate approved its version of the tax bill in May 1986. We, of course, obtained the big Tax Reform Act (TRA) in September of 1986.

The important thing to mention is that all these proposals, as well as the final TRA, contained provisions that would significantly increase taxes on capital. In consequence, in late 1984, market participants knew what was in the wind: a tax increase on capital, which would reduce the after-tax rates of return on capital and the desired capital stock in the US, relative to what it would be without new tax increases.

In consequence of the anticipation of TRA, investment in US real capital didn't look as attractive as it had. Hence, at the margin, investors started shifting their capital toward other foreign opportunities, and the dollar started to fall. This continued until early in 1988, when the capital stock levels in the US began to approximate desired levels (those that were consistent with TRA).

Additional evidence

The supply-side perspective of exchange rates explains the turning points (1980 and 1985) and subsequent dollar trends. But is there additional evidence that supports the supply-side analytics? The answer is yes! For example, a recent study published by the Economic Growth Center at Yale University examines the exchange rate between the US dollar and the British pound from 1870 to 1984. It shows that over this long period, a reduction in US taxes relative to GNP leads to an appreciation of the dollar, and a reduction in British taxes relative to GNP leads to a depreciation of the dollar. The study also shows that the ratio of budget deficits to GNP had no effect on the dollar-pound exchange rates over time.

More recently, recall that in early Spring 1988, Germany proposed to withhold 10% of interest payments. This would have reduced after-tax rates of return on investments. In consequence, this proposal sent the German mark (DM) tumbling. When, in November 1988, the Germans indicated that they were deferring the proposal, the DM bounced back.

The Japanese slashed income tax rates in October 1988, and the yen took off on the up side. Much the same thing happened to the pound in March 1988, when the British announced that they were cutting their top tax rates by 20 percentage points.

Read his lips

The most recent dollar action is consistent with the supply-side perspective. As soon as Mr. George Bush was elected, the tax-increase crowd — which includes virtually all the press, bureaucrats, most Democratic politicians, and many Republican politicians — began to hammer away at the President-elect. They used the so-called federal deficit problem as a Trojan horse for tax increase. Even though the voters had read Mr. Bush's lips and had approved his "no new taxes" pledge, the tax-increase crowd pulled out all the stops. The market participants thought that Mr. Bush would be forced to cave in. In consequence, the dollar took a real drubbing. However, as the President-elect has assembled his White House and economic teams, it has become clear that they have read Mr. Bush's lips. Hence, the dollar's plunge has slowed.

In fact, on the basis of Gorby's announcement to unilaterally reduce Soviet troops by 500,000 over the next two years, the dollar soared. This reaction (on the assumption that Gorby was telling the truth) is completely consistent with the supply-side perspective. The thinking is that if the Soviets reduce their troop strength, Mr. Bush will be able to implement his flexible budget freeze (no new taxes) via, in large part, cuts in defense expenditures. Hence, the Gramm-Rudman Budget Act's deficit targets could be met with no new taxes. In fact, perhaps the President-elect could even reduce taxes. Recall, that he has pledged to reduce capital gains taxes.

IMPLICATIONS: *The course of the dollar will largely be set by the future course of tax policy. If Mr. Bush (and the American voters) are able to hold off the tax-increase crowd, the dollar will resume the climb that it began in the Spring of 1988. We think that this is a likely outcome. If Mr. Bush is forced to cave in on his no-tax pledge, he will lose virtually all credibility and power. In short, the Congress and the press would hound his administration on all issues. This he knows and can't afford.*

Mr. Bush knows that everything is on the tax line. In fact, there is some chance that Mr. Bush will pull out all the stops to reduce capital gains taxes. This would eliminate the so-called Bush wimp factor forever. It would also send the dollar rocketing upward. Need we mention where the dollar would head if a tax increase became a reality?

— Steve H. Hanke

STOCKS & T-BONDS

Bear's hibernation ending

Lucklustre — better categorized as deadly lethargic — volume, sinking breadth, and falling price-earnings ratios (see Charts 6 to 8) are the visible confirming signs of an ongoing bear market, which has, as yet, not begun to face falling earnings and corporate insolvencies.

The culprits, of course, are the booming economy — now operating at 84.2% of capacity under some arcane statistical computation but probably a great deal closer to 98% in reality — rising interest rates, and the inverting yield (to which we alluded in *FC&CC*, Oct. 23, 1988). As can be seen in Chart 9, the yield curve has already inverted in the two to 30 years and five to 30 years portion.

The bear's laborious one-year uphill climb is about to come to an end.

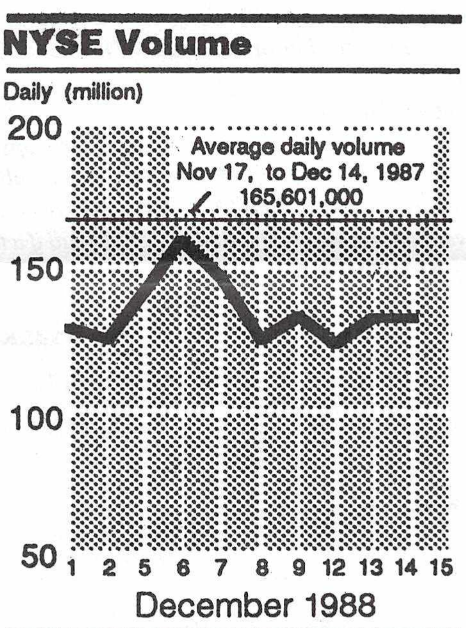
STRATEGY: *We have three stock-market-related positions:*

a) Short March '89 S&P via long March 270 puts. Remain long these puts as the S&P 500 now stands 3,000 points above its theoretical path (see Chart 10 and discussions in previous market letters).

b) Short Value Line/Long S&P, now rolled over to March '89, weighted according to contract value. This spread is predicated on the known characteristic of late bull markets, early bear markets to show decreasing breadth. Chart 11 indicates that the spread has been moving in our favor. Weaknesses in the past few days may mean that seasonal phenomenon called the "January effect" (that is, secondary issues outperform, for some as yet unfathomed reason, large capitalization stocks every January) is about to take place once more. This phenomenon has been so widely disseminated that it would be positively strange if it repeated itself. At any rate, place protective stops on closes below 1.1290 on the ratio chart (Chart 11).

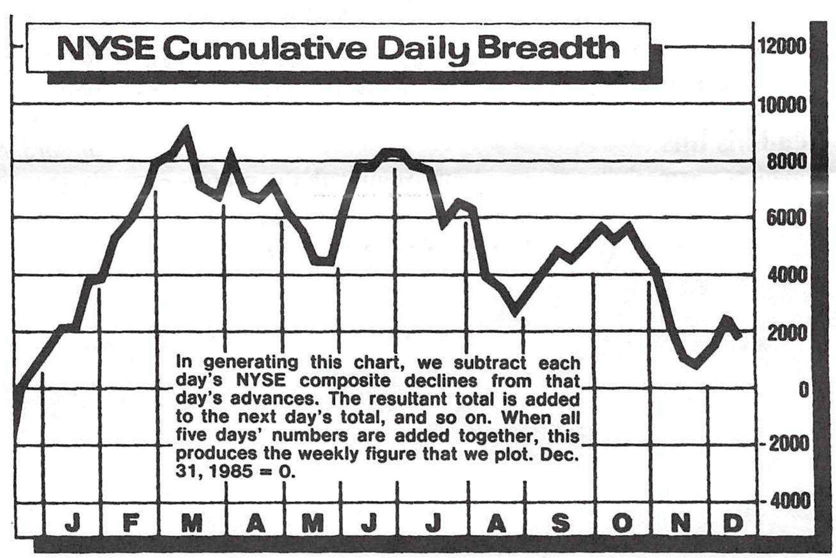
c) A new position, spread of long 3 March '89 T-bonds/ short 2 March '89 S&P 500. The stock market rally has weakened somewhat this spread in recent weeks (see Chart 12), but the rationale for the trade remains as good as it has ever been: stock prices are overvalued vis à vis bonds on a current return basis, especially when taking into account "quality" considerations (see last month's FC&CC *for a broader discussion of this issue). Maintain spread.*

Chart 6



Source: *London Financial Times*

Chart 7

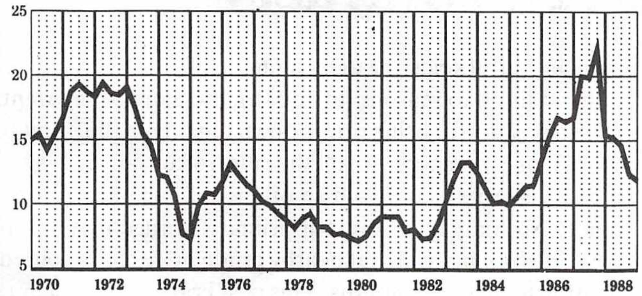


Source: *Barron's*

Chart 8

Price-Earnings Ratios

P-E ratio of the S&P 500; quarterly data

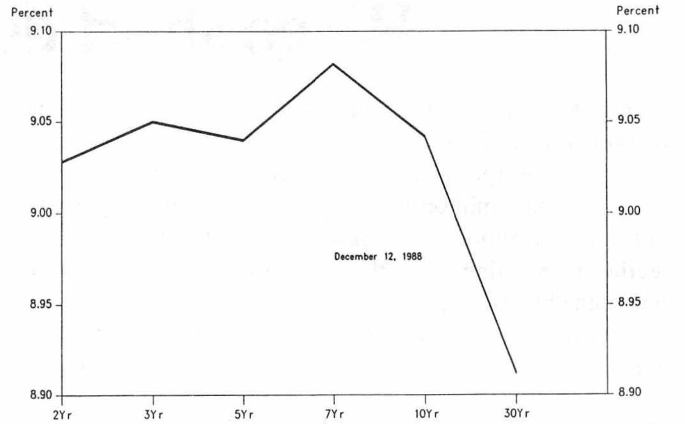


Most indexes of stock prices have risen this year, but the P-E ratio of the S&P 500 has fallen to 11.9 times the latest 12 month's earnings from 16 at the end of 1987.

Source: *Wall Street Journal*

Chart 9

THE 2- TO 30-YEAR PORTION
OF THE YIELD CURVE HAS INVERTED



Source : Merrill Lynch

Chart 10 – THEORETICAL BEAR MARKET PATH FOR THE S&P 500

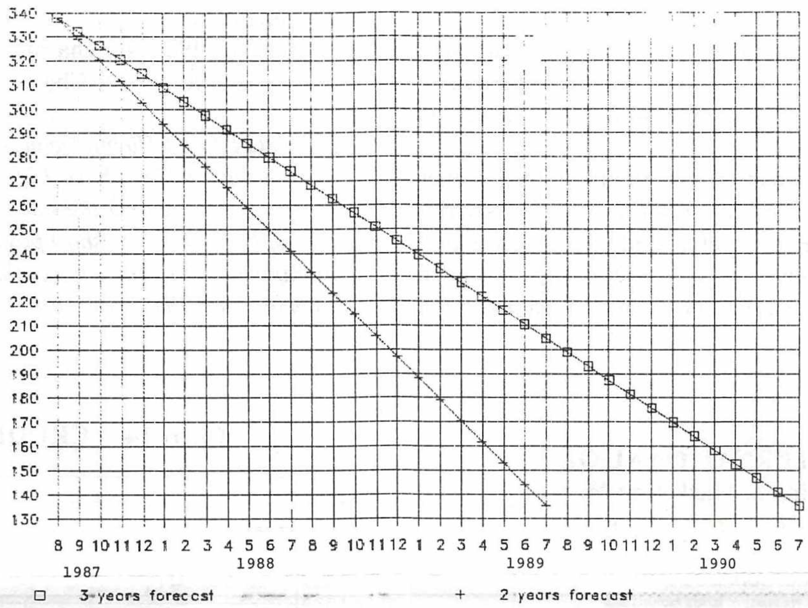


Chart 11 – S&P MARCH/VALUE LINE MARCH

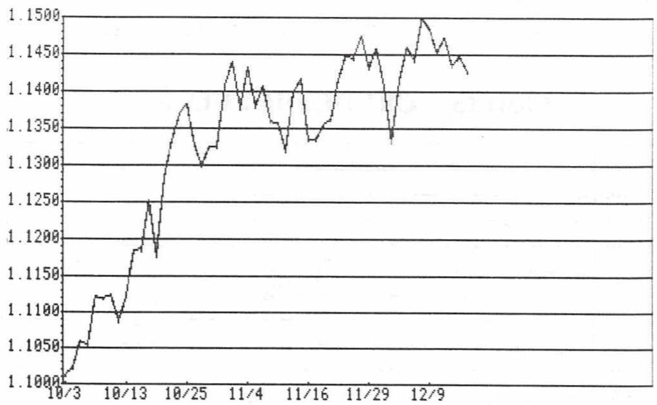


Chart 12 – US T-BONDS MARCH/S&P MARCH

CRUDE OIL

We go short deferred contracts

Rising Opec output of recent months has been flooding the market. True or false? False.

Opec's overproduction, estimated at somewhere between 3 million and 5 million barrels per day (b/d) has apparently not come on-shore, or at least no reputable statistical collecting agency (including the International Energy Agency) has been able to locate the surplus oil.

Bulls, of course, argue that demand has been expanding at a spectacular 3.8% rate in the fourth quarter, thus absorbing excess supplies. This explanation strains the imagination of even the most credulous energy analysts (the IEA itself has forecast a 1.5% increase for the fourth quarter).

What is more likely is that some Gulf producers, in particular Saudi Arabia, have been storing their production in the high seas and other unreported storage depots with at least three purposes in mind:

a) Raising production dramatically in the months leading to the Opec meeting, flexing "muscles" in the face of Iraq and the UAE cheating but *avoiding sales* so as not to send the market tumbling down.

b) Besides the reason given in (a), the Saudis and their allies may have been "playing" the market, waiting for prices to rise in response to the agreement before unloading excess production. If our supposition is correct, the strategy has been working relatively well, as crude prices have regained more than $3/barrel since the agreement.

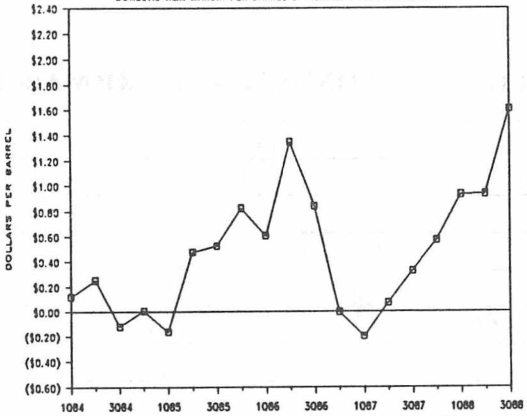
c) In addition to reasons (a) and (b), the Saudis may want to be in a position to bring prices down quickly in the event that other Opec members violate the rules, after Jan. 1, 1989.

These reasons explain an otherwise inexplicable occurrence: Not only have levels at primary storage in developed countries not budged, but nearby crude prices have soared in relation to deferred months. This past Friday, nearby January '89 closed at $16.62, a $1.43/barrel premium to the July '89 contract. Very favorable refining and marketing margins (see Chart 13) explain some of the strength in the immediate delivery positions, but Opec's November production of 22.6 million b/d should have handily accommodated this demand. Unless, of course, the crude never arrived.

In view of this phenomenon, we would bet (as we did the last time the market went into backwardation — the last two quarters of 1985) on sharply lower prices via the sale of *deferred* contracts (see Charts 14 and 15).

STRATEGY: *Having been stopped out of the February '89 contract on closing above 15.95, we suggest reinstating short positions in crude via the sale of 6-month deferred contracts, that is, July '89. These short positions should be rolled forward monthly so as to remain 6 months ahead of the spot West Texas Intermediate. Place stops on July '89 at $16.00, close only.*

Chart 13 – INTERNATIONAL OILS
Domestic Refining & Marketing Margin
Per Barrel of Refined Products Sold



Source: *Merrill Lynch*

Chart 14 – CRUDE OIL JAN 89

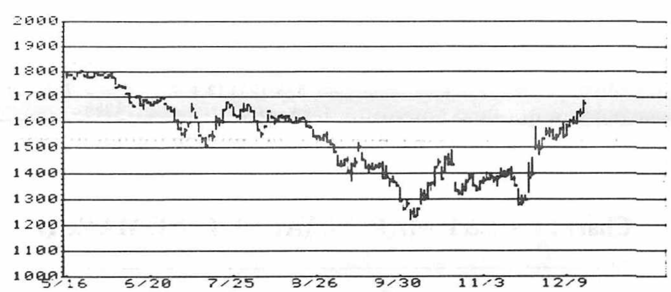


Chart 15 – CRUDE OIL JULY 89

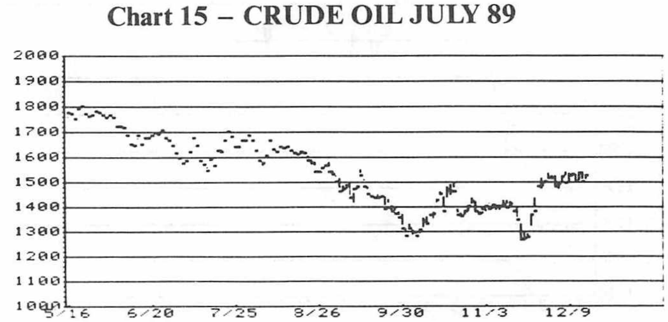
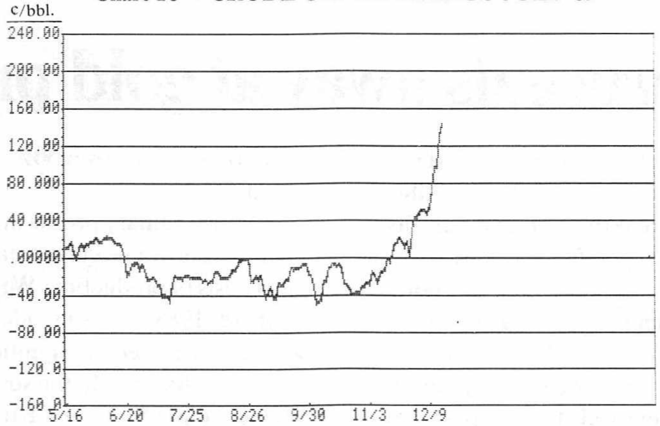


Chart 16 – CRUDE OIL JAN. MINUS JULY '89



COPPER

Prices to go even higher

As we anticipated last month, extreme supply tightness drove copper prices to all-time highs. Just seven days ago, nearby December Comex hit $1.6475/lb. before easing to close this week at $1.52/lb.

Even more noteworthy than the record high *nominal* prices — which in real terms are still well below levels reached in the '60s — is the dramatic premium commanded by nearby December over March '89 (see Chart 17). This steep backwardation has had the effect of slowing LME/Comex warehouse withdrawals: to a weekly average of 2,200 tonnes in November from 8,300 tonnes in October. The pace slowed even further in the first two weeks of December.

Will the backwardation create more copper? No; it will merely redistribute supplies and postpone needs so as to give medium-term output and consumption a chance to find a better equilibrium.

The settlement of the 57-day Peruvian strike is likely to alleviate somewhat the market's tightness, but clearly, lost output will not be compensated. On the other hand, planned production increases in Chile (to 1.242 million tonnes in 1989 from 1.105 million in 1988), the United States, Canada, and Papua New Guinea will restore some normality to the "immediate delivery" positions, thus working to narrow backwardation as the new year progresses.

Strong economic growth in North America, the EEC, the UK, Japan, and the NICs is fuelling higher-than average increases in copper consumption. Superimposed on this normal demand is the *demand for rebuilding inventories*, which now stands somewhere between 2.8 and 4.0 weeks of usage (see, for example, *FC&CC* Dec. 20, 1987). Plans to rebuild inventories can add approximately 150,000 tonnes to demand for every additional week of usage desired. For example, to move from four week's usage to a more "normal" eight weeks' usage, demand rises by 600,000 tonnes — more than half of Codelco's 1988 output!

In short, market fundamentals remain constructive. Prices are likely to go substantially higher until either economic activity peaks and/or worldwide inventories reach desired levels — a minimum of seven weeks and possibly as much as 10 to 12 week's usage. We may be still many months away.

STRATEGY: *Remain long March '89, raising stops to 118.00, close only. Remain long March 120 calls, recommended last month at around 9¢/lb.*

Chart 17 – COPPER DEC '88/MARCH '89

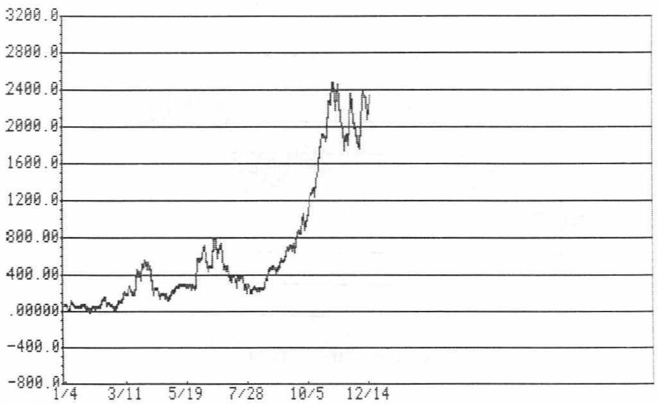


Chart 18 – COMEX COPPER MAR 89

GOLD

Bacteria eats away at gold prices

The recent dramatic increase in gold production around the globe is likely to turn explosive with the use of Thiobacillus ferro-oxidans, a biotechnological breakthrough that permits a much better recovery of gold from specific ore types.

Pioneers in the field, General Mining Union Corporation of South Africa, will be replacing aging roasters at its Fairview mine with a bacterial oxidation plant to process about 1,000 tonnes of concentrate per month. A pilot 10 tonnes/day plant has been operating well for the past two years, with recoveries improving from *20% of the gold to between 92% and 97%*!

In a recent *Financial Times* of London article, it was stated that "the treatment of refractory ore is not the only use for biotechnology in gold recovery. Some ores contain such small amounts of gold-pyrite mix that it is not usually worthwhile to attempt to concentrate or extract them. However, bacteria can profitably be used to recover the gold" with a relatively simple process. Locked up in sulphide rock lies in wait, for recovery, over 30% of the gold in the non-communist world.

Extraordinary profits in gold production are clearly pulling prices down — via increased production — towards marginal costs of production. We elaborated this thesis in *FC&CC*, Sept. 18, 1988 and concluded that gold prices, *in real terms*, were likely to decline significantly over the next few months and years. As a result, the strategy we favored was selling gold versus the purchase of CRB futures. Chart 20 illustrates the validity of this concept.

STRATEGY: *Gold prices seem set to make fresh* lows *in the bear market that began in January 1988.*

Maintain long CRB/short gold spread, which should have been rolled over to March '89 and April '89 respectively, as advised last month; leave stops at .540.

Maintain long 5 December '89 silver/short 4 December '89 gold; place stops at 70/1, close only.

Chart 19
COMEX GOLD FEB 89

Chart 20
CRB MARCH/GOLD APRIL

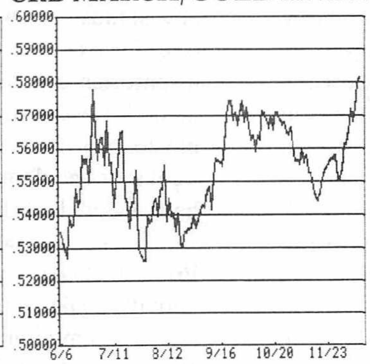


Chart 21
GOLD DEC 89/SILVER DEC 89

SUGAR

Waiting to get back in

Extraordinary increases in the open interest (rising from a November average of 116,000 contracts to a high of 151,370 contracts last Thursday) accompanied by a bullish consensus well above 80% for a number of weeks, should have been sufficient to warn us of a strong reaction.

While the reaction may still have a while to go, the market's fundamentals remain constructive, and prices are likely to rise over the medium term.

STRATEGY: *Sold out just below 11.00 for March '89, for a handsome profit. We are awaiting a new buying opportunity.*

Chart 22 – N.Y. #11 SUGAR MAR 89

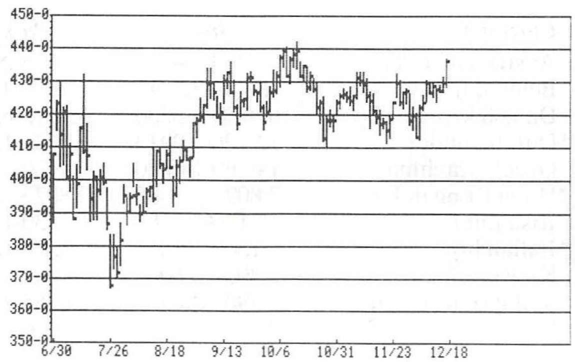
WHEAT

Why wait for spring? Buy now.

Dry conditions threaten the winter wheat crop, which lies dormant during the winter and is harvested in June and July. Coming atop reduced wheat supplies, crop problems could ignite a strong advance.

STRATEGY: *We are long March '89 wheat as per the Hotline Update of Dec. 9. Maintain stops at 410, close only.*

Chart 23 – CBT WHEAT MAR 89



FRIEDBERG CAPITAL MARKETS

Recommended bond portfolio allocation:

New Zealand dollar bonds	40%
US dollar floaters	60%

Our current recommended bond portfolio mix includes a 40% investment in NZ dollar bonds. We have repurchased NZ dollar bonds in the 0.62 to .63 NZ$/US$ range on a pullback from the peak trading level of 0.725 NZ$/US$.

The NZ currency has recently depreciated as a result of political uncertainty. On Dec. 12 Roger Douglas — the architect of New Zealand's economic turnaround — received his walking papers. The financial markets initially responded negatively to this news with both the NZ dollar and NZ bonds trading lower. The damage, however, proved to be not as severe as anticipated, prompting us to maintain our bullish stance that NZ dollar bonds be bought on a dip below .6250, basis spot.

For Australian dollar bond holders, we were looking to switch into NZ dollar bonds when the cross rate bewteen NZ$/A$ broke upwards from a substantial downtrend. This occurred on Dec. 9, and we subsequently instituted many of these switches. We project that the NZ dollar bonds will significantly outperform Australian dollar bonds if and when this breakout becomes more permanently entrenched.

Chart 24 – FOREIGN CURRENCY BONDS

Date: December 15, 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	105 1/4	106	12.44		02/04/88-02/04/89
BANK OF NOVA SCOTIA 15/09/89 18 1/2% RRSP eligible	102 1/8	102 7/8	13.74		15/09/88-15/09/89
WELLS FARGO (semi annual) 12/05/89 16 1/8%	100 3/8	101 1/8	13.37		12/11/88-12/05/89
MCDONALD'S (semi annual) 15/08/90 16 3/4%	103	103 3/4	14.57		15/08/88-15/02/89
TOURIST HOTEL (N.Z.) 04/06/93 zero coupon	54 1/8	55 5/8	14.09		matures 04/06/93
AUSTRALIAN DOLLAR DENOMINATED BONDS					
COMMONWEALTH BANK OF AUSTRALIA 01/07/94 14%	100 1/8	100 7/8	13.70		01/07/88-01/07/89
WORLD BANK 15/03/93 12 3/4% RRSP eligible	97 7/8	98 5/8	13.15		15/03/88-15/03/89
CAN.IMP.BANK OF COMMERCE 13/03/91 13% RRSP eligible	94 3/4	95 1/2	15.45		13/03/88-13/03/89
DANISH KRONE DENOMINATED BONDS					
WORLD BANK 20/11/92 9 3/4% RRSP eligible	100 5/8	101 3/8	9.30		20/11/88-20/11/89
STOCKHOLM 10/11/91 10 5/8%	103 7/8	104 5/8	8.72		10/11/88-10/11/89
DEUTSCHE MARK DENOMINATED BONDS					
QUEBEC HYDRO 1/5/96 5 1/2 RRSP eligible	98	98 3/4	5.71		01/05/88-01/05/89
SWISS FRANC DENOMINATED BONDS					
GOVT.OF AUSTRALIA 30/10/98 5%	102 3/8	103 1/8	4.60		30/11/88-30/10/89
JAPANESE YEN DENOMINATED BONDS					
GOVT.OF CANADA 23/7/93 5 5/8% RRSP eligible	103 3/4	104 1/2	4.51		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)	99.98	100.28	8 1/16%		24/09/88-28/12/88
REPUBLIC OF ITALY 30/4/93 3 mo Limean (quarterly)	98.78	99.18	8 5/8%		31/10/88-31/01/89
REPUBLIC OF PORTUGAL 8/12/93 (semi annual) 6 mo LIBOR +5 B.P.	99.81	100.11	9.425%		08/12/88-08/06/89
L.D.C. PAPER DENOMINATED IN U.S.DOLLARS					
ISSUER MAT.DATE/COUPON	BID	OFFER	CUR.COUP.		
BANCO CENTRAL De CHILE (restructured) 12mo.LIBOR +1 1/8 (annually)	55	58	9.0625%	* 15.625%	20/01/88-20/01/89
ARGENTINA 15/2/92 BONEX ser.82 LIBOR (sem.ann.)	.8570	.8700	8 9/16%	** 19%	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 F/MICHCM

FOREX RATES & UPDATE

Currency	*Spot*	*3-Month*	*12-Month*	*Comments vis à vis US$*	*Comments vis à vis DM (Spot DM: 1.7550)*
Australian dollar	.8470-.8490	.8355-.8378	.8035-.8070	Neutral	Neutral
Belgian franc	36.99-37.01	36.91-36.95	36.22-36.39	Remain short**	Neutral
Danish krone	6.8200-6.8230	6.7915-6.7995	6.7250-6.7480	Remain short**	Neutral
*Dutch guilder	1.9906-1.9913	1.9726-1.9737	1.9212-1.9234	Remain short**	Cover
Greek drachma	146.60-146.70	148.80-151.10	154.70-163.80	Remain short	Remain short
*Hong Kong dollar	7.8075-7.8085	7.8025-7.8075	7.7725-7.7935	Neutral	Buy
Irish punt	1.5170-1.5185	1.5230-1.5255	1.5355-1.5400	Remain short**	Neutral
*Italian lira	1300-1302	1308-1311	1330-1339	Remain short**	Cover
Kuwaiti dinar	.28030-.28060	.27844-.27916	.27485-.27675	Remain short	Neutral
Malaysian ringgit	2.6900-2.6930	2.6585-2.6645	2.5750-2.5980	Neutral	Neutral
*New Zealand dollar	0.6235-0.6255	0.6150-0.6185	0.5905-0.5975	Remain long	Buy
Norwegian krone	6.5300-6.5400	6.5620-6.5750	6.6500-6.6750	Neutral	Neutral
Portugese escudo	145.60-146.00	147.05-148.10	150.85-153.75	Neutral	Remain long
Saudi Arabian riyal	3.7500-3.7510	3.7550-3.7575	3.7575-3.7605	Remain short	Remain short
Singapore dollar	1.9445-1.9455	1.9260-1.9285	1.8895-1.8965	Neutral	Neutral
Spanish pesetas	114.00-114.10	114.48-114.68	117.10-117.60	Remain short	Neutral
Swedish krona	6.1010-6.1110	6.1115-6.1245	6.1385-6.1635	Remain short	Neutral

Explanatory Notes

*Indicates change in recommendation from last issue.

**Denotes change as per hotline update of December 13.

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, November 22: No changes. Market letter will be mailed tomorrow.

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

Flash update, Monday, November 28, 11:45 a.m.: We recommend that the 14.65 stop in crude oil, basis the January contract, be cancelled and a new stop be put at $15.95, basis February, close only.

Opec's new agreement resembles a marriage of convenience: For the sake of *some* agreement, the Saudis left out of the final communique the idea of a $15 floor and went along with the $18 reference price. It is quite clear, however, that the Saudis mean to keep oil prices below $15/barrel and are reserving the right to sell *above* their quota anytime prices reach above $15/barrel. This level translates into a $15.80-$16.00 barrel WTI price (the N.Y. Mercantile Exchange Contract).

Furthermore, while the "positives" are already out, the negatives are about to appear: The agreement speaks about starting in January, the Iraqis are already preparing to ask for increases in their quotas at the next meeting (in line with their relentless increase in production), there is no reason to believe that the UAE will be paying more than lip service to this agreement very much what they are doing now, etc.

Tuesday, November 29: We have revised our stop in the crude oil position to 1595, basis February, close only, up from 1465 basis January as per our flash update of Monday, November 28, at noon.

Friday, December 2: We have revised our stop in crude oil to 1595, basis February, close only, up from 1465, basis January, as per our flash update at noon on Monday.

Tuesday, December 6: Raise stops in March sugar to 1045, close only.

Flash update, Thursday, December 8, 10:35 a.m.: Buy March wheat at market, placing stops at 410, close only.

Friday, December 9: Two new recommendations this week:
1. As per Tuesday's flash update, Raise stops in March sugar to 1045, close only.
2. As per Thursday's flash update, buy March wheat at market, placing stops at 410, close only.

Flash update, Tuesday, December 13, 1:45 p.m.: Sell March Japanese yen, SF, DM, and other EMS currencies at market. Place initial stops at 8364, 7027, and 5878 respectively, close only. This will replace our regular Tuesday update if there are no other changes.

Flash update, Thursday, December 15, 1:15 p.m.: Liquidate long sugar positions at market, accepting profits.

Friday, December 16: A recap of the week's activities:
1. As per our flash update of Tuesday, December 13, we are short March yen, SF, DM, and other EMS currencies. Lower stops to 8305, 7027, and 5878 respectively, close only.
2. We have liquidated long sugar positions as per yesterday's flash update.

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