FRIEDBERG'S
COMMODITY & CURRENCY COMMENTS
Friedberg Commodity Management Inc. Volume 10, No. 2 February 20, 1989

An unpleasant choice

Increasingly, US monetary policy will be shaped by foreign exchange markets.

The US domestic expansion, if left alone, is likely to die of natural causes: rising unit labor costs eating into profit margins and consequently a downturn in capital spending (for a fuller explanation, see next article). At the same time, the very high level of consumer debt is likely to put a crimp, sooner or later, on consumer expenditures.

Death by natural causes is otherwise called a soft landing. It need not bring in its wake (no pun intended) a severe contraction; it is, for the most part, a gentle affair, characterized too as a slowdown or, at worst, a mild recession. Dr. Hanke's article makes this forecast *on the basis of present circumstances*, targeting the beginning of the soft landing to somewhere between the second and third quarter of this year.

But here is the rub. A slowing US economy has a detrimental effect on capital inflows (see last month's "Are foreign exchange markets perverse?") and diminished capital inflows, in turn, *cause the US dollar to fall.*

The sensitive dollar

Evidence of the US dollar's sensitivity to indications of a slowing economy was given last week. First, commerce department figures indicate that the growth in manufacturing orders fell to its lowest rate since late 1986. Also, reported by the Bureau of Economic Analysis was a strong drop in inventories following two months of modest gain. And The National Association of Purchasing Managers Composite Index fell rather sharply, although it managed to remain above 50, still a green light for the economy. Perhaps manufacturers were beginning to feel the impact of the cost squeeze after all.

At the same time, car sales for the period Feb. 1 to Feb. 10 were reported in mid-week, showing a 16% drop from year-ago levels. This statistic bears watching for indications of consumer exhaustion.

Be that as it may, the US dollar responded negatively to these bits of evidence of a slowdown, falling 3.5% against the yen and 3.2% against the DM in less than two weeks.

We return to our scenario. A "soft landing" begets a weakening dollar. As the US dollar weakens, the Fed is put in a dilemma: To defend the dollar, *they must hoist interest rates*. At its December 13-14 meeting, the Fed voted to tighten credit policy immediately and again in early 1988 (by an overwhelming 11-1 vote), noting that "the risks were in the direction of greater inflation... these risks would be heightened if the dollar were to decline significantly from current levels." That was said with $/DM rates of 1.76 and $/yen rates of 124, shortly before they bottomed out.

In plain English, the Fed would be *forced* to *raise* interest rates to stop the dollar from trading below DM1.70 and ¥120.

When a soft landing turns hard

nd now, the $64,000 question: What do you get when you raise interest rates during a soft-landing? A *hard landing*.

Those who look for interest rates to fall at the first sign of recession are wrong, *very wrong*. Those who think we can manage with *just* a soft landing are, again, *very wrong*.

The trading implications of this scenario follow Dr. Hanke's comments.

In this issue

How a soft landing can turn into a hard one, and how to cushion the blow with Eurodollar puts. Getting nimble in currencies. Platinum makes a comeback, despite Ford. Don't disturb the bear in our precious metals spreads. Stay the course in sugar, and lament the loss of magic down in the land of the kiwi. Contributions by Albert D. Friedberg, Dr. Steve H. Hanke, Daniel A. Gordon, and Michael D. Hart.

THE ECONOMY

Real and monetary indicators point down

We first flashed a yellow light on the economy in September 1988. Since then, we have grown more firm in our conviction that a yellow light is prudent. Indeed, with this writing, we are intensifying that yellow signal. We base our heightened level of anxiety on our reading of real and monetary developments.

To monitor the real side of the economy, we have developed a supply-side spread model. When spreads are positive, they signal that it is profitable to increase supply. Hence, we can anticipate economic growth. As positive spreads become wider, we can anticipate accelerating growth rates. When these spreads become narrower, we can anticipate a deceleration in growth rates. Negative spreads, of course, signal a contraction in real economic activity.

At present, both the economy-wide and the manufacturing spreads are positive (see Chart 1). However, they are narrowing. Hence, we can anticipate slower rates of real GNP growth.

Durable goods deceleration

Before closing our discussion of supply-side spreads, it is important to mention that the spread for the durable goods component of the manufacturing sector has declined (since manufacturing's peak of 9.7% in the third quarter of 1987) more rapidly than the spread for manufacturing. While the durable goods spread remains healthy, its deceleration is disconcerting, because growth in the durable goods sector has contributed a disproportionately large share to the growth in GNP since the October 1987 stock market crash. With a narrowing durable goods spread, we anticipate slower growth rates in durable goods output. If this occurs, it will reduce a major force that has propelled the real growth of GNP since late 1987.

This general picture (a slow-down, but not necessarily a recession) is confirmed by other related measures of the real economy's strength. For example, consider cash-flow margins (gross cash flow as a percent of corporate output). These margins represent a broad measure of profitability. They usually peak in the middle of expansions, and then decline during late phases of expansions and during recessions.

Cash-flow margins peaked at 18.4% in mid-1985 and have been declining ever since. In the fourth quarter of 1988 they fell to 15.6%, down from 16.4% a year earlier. This trend signals a slowdown in economic growth.

If this cyclic decline in cash-flow margins weren't enough, the Tax Reform Act of 1986 phased out accelerated depreciation provisions in the tax code. In consequence, starting in 1989, cash-flow margins will be lower than they would have been if the accelerated depreciation provisions had not been phased out.

Monetary signals

Although the real economy is currently strong, our supply-side spreads and cash-flow margins signal a coming slowdown. Let's turn to some vital monetary measures to determine if they confirm that such a slowdown is in the cards.

We begin our monetary analysis with a discussion of the spread between long- and short-term interest rates. The study of this spread is often called "yield curve analysis," because the yield curve is a line that graphically connects interest rates on securities against their maturities. If long-term rates exceed short-term rates, the interest rate spread is positive and the yield curve has a positive slope. Alternatively, if short-term rates exceed long-term rates, the spread is negative and the yield curve has a negative slope. This is often referred to as an inverted yield curve.

The shape of the yield curve (rate spreads) provides valuable information about the future course of interest rates and the economy. Consider the future course of interest rates. Market participants, not forecasters, provide the best information about the course of future interest rates (see: "Forecasters versus the Markets," *FC&CC*, July 26, 1987). Long-term interest rates reflect market participants' forecast of where short-term rates are headed in the future. In consequence, the spread between long and short rates predicts the future direction of short-term rates. When the spread is positive (long rates exceed short rates), short rates are poised to move higher. Similarly, when the spread is negative, short rates are poised to fall. A check of the record confirms that in *the long run* these forecasts are correct.

There is a good economic reason that explains why the spreads are such an excellent predictor for the future course of short rates. When short rates exceed long rates, the interest cost of engaging in economic activity at present is higher than it is expected to be in the future. In consequence, there will be an intertemporal shift of economic activity from the present to the future, and economic activity in the present will slow down. This deceleration in economic activity will eventually take the upward pressure off short rates, and they will decline.

Alternatively, when the interest rate spread is positive, the interest cost of engaging in present economic activity is lower than it is expected to be in the future. Hence, there will be an intertemporal shift of economic activity from the future to the present, and economic activity in the present will pick up. This acceleration in economic activity will eventually put upward pressure on short rates, and they will increase.

The interest rate spread is, therefore, not only a good guide for the future course of short rates, but also of economic activity. When the spread is positive, the economy should pick up speed, and it does. Alternatively, a negative spread signals a coming economic slowdown.

Chart 2 displays the spread between 30-year US Treasury bonds and federal funds rates. Throughout most of 1988 the positive spread was narrowing, and in 1989 it has turned negative. It is interesting to mention that the alterations in the shape of the yield curve over the past year have been primarily the result of increases in short rates. This leads us to conclude that the Fed tightening, which has pushed up short rates, has kept inflation expectations, which are factored into long rates, under control.

Rate trend signals slowdown

The trend in spreads signals an economic slowdown. It also confirms the conclusion obtained from our reading of the supply-side spreads.

Another useful monetary indicator for the future course of the economy is the rate of growth in the inflation-adjusted money supply, specifically M2 (currency, checking account balances, money market funds, and interest-bearing bank account balances). When inflation-adjusted (real) M2 increases, we can anticipate a pick-up in economic activity, and vice versa. The evidence supports this assertion.

There is a good reason for the positive relationship between real M2 and economic activity. Money is used to settle economic transactions. When the real M2 declines, it means that inflation has risen faster than nominal M2. Hence, consumers and businesses will feel squeezed for money balances (liquidity). To put it another way, when real M2 declines, the purchasing power of money balances has declined. In consequence, consumers and businesses will feel illiquid, and they will attempt to rebuild their money balances. This can be accomplished by either slowing their purchases of goods and services or by selling assets. Alternatively, if real M2 has risen, the purchasing power of money balances and liquidity have increased. In consequence, consumers and businesses will attempt to reduce money balances to desired levels. This can be accomplished by purchasing more goods and services.

The real M2, by measuring the real value of money balances (liquidity), gives us another monetary indicator for the future course of economic activity. Chart 3 shows us that real M2 (and other related monetary aggregates) is falling. This suggests that the economy will slow down as consumers and businesses attempt to rebuild their liquidity.

Conclusions: The key real and monetary indicators suggest that the economy will slow down in the coming months. This slowdown won't become apparent until after the second and perhaps the third quarter of 1989, because the drought of last summer distorted the GNP statistics. Specifically, the drought reduced the reported GNP levels for the last three quarters of 1988. These downward distortions will all be added back to the GNP data for the first quarter of 1989. Hence, the first-quarter data for 1989 will give the appearance of much more economic strength than is actually the case. Indeed, the first quarter GNP number will be about 2.75% higher than it would have been if there hadn't been a drought. After that point, the drought distortions will be absent from the GNP data, and the anticipated slowdown will become apparent.

– Dr. Steve H. Hanke

Chart 1 – Supply-Side Spreads

(Rates of Change)

Period		Economy-Wide	Manufacturing
85	1	1.8%	6.9%
	2	1.4	9.5
	3	2.7	7.5
	4	2.0	7.9
86	1	4.7	7.3
	2	3.5	3.7
	3	2.0	3.7
	4	3.1	3.4
87	1	0.0	5.7
	2	1.8	8.5
	3	4.1	9.7
	4	3.8	9.6
88	1	4.8	7.9
	2	2.1	6.5
	3	1.1	7.0
	4	1.0	6.1

Notes 1) Rates of Change are calculated on a year-over-year basis.
2) Supply-side spreads (=) percent change in productivity (+) percent change in prices (-) percent change in unit labor costs.

Chart 2 – Interest Rate Spread

Date	(1) 30-year T-Bonds	(2) Fed. Funds	(1 - 2) Spread
Feb 89	8.97 %	9.22 %	-0.25 %
Jan 89	8.90	9.12	-0.22
Dec 88	9.11	8.48	0.63
Nov 88	8.99	8.32	0.67
Oct 88	8.90	8.24	0.66
Sep 88	9.03	8.20	0.83
Aug 88	9.36	7.99	1.37
Jul 88	9.37	7.75	1.62
Jun 88	9.02	7.49	1.53
May 88	9.22	7.10	2.12
Apr 88	8.91	6.81	2.10
Mar 88	8.58	6.57	2.01
Feb 88	8.42	6.60	1.82

Chart 3
Trends in Bank Reserves and Selected Monetary Aggregates

(Annualized Real Rates of Growth)

	July 1988 / Nov. 1987	Nov. 1988 / July 1988	Jan. 1989 / Nov. 1988
Bank Reserves	1.1	-3.7	-11.6
Monetary Base	3.5	1.2	-2.6
M_1	1.4	-2.4	-5.7
M_2	2.2	-0.3	-4.6

Real growth rates are nominal rates adjusted for changes in the implicit GNP deflator.

INTEREST RATE FUTURES

Purchasing puts

The inversion of the yield curve, first pointed out in our issue of Oct. 23, 1988, continues (Chart 4), and now, for the first time since 1982, Fed Funds yield more than 20-year Treasuries.

The increasing possibility of a soft landing (see opening article) promises to create foreign exchange problems for the dollar. In the present semi-fixed foreign exchange regime, volatility is properly transferred to the interest rate area. Therefore, we expect interest rates to rise further (and strongly) at the first sign of a slowdown (let alone, a recession).

STRATEGY: *Given the low implied volatility of Eurodollar options, , we strongly urge the purchase of puts.*

Buy June '89 and/or September '89 Eurodollar puts 89.75 striking, at present levels.

Chart 5 – EURODOLLAR MARCH 89

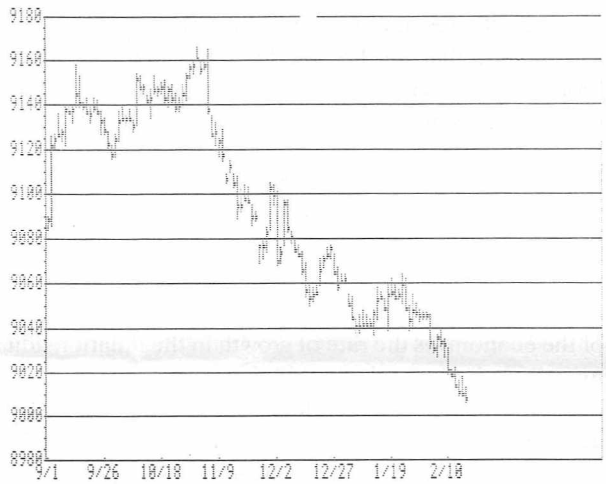
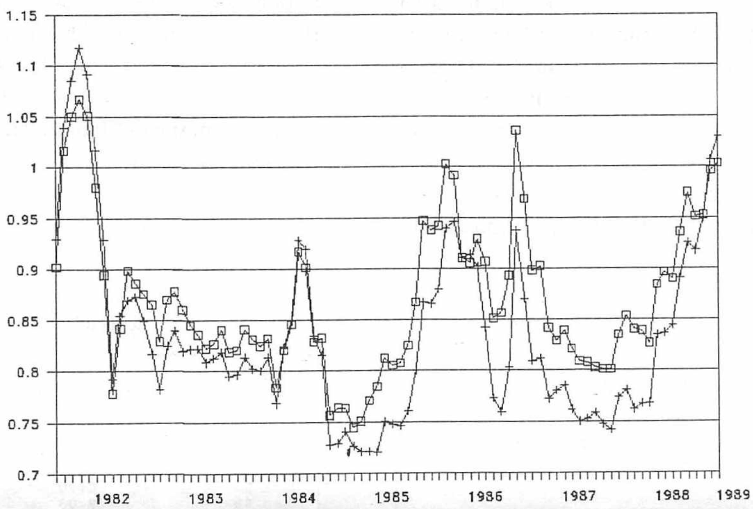


Chart 4 – YIELD CURVE



STOCK MARKET INDEXES

Too early for the bull

US stocks indexes reached an important milestone last week: They had retraced approximately two thirds of the entire bear move (see Charts 6 and 7). Technicians pay a great deal of attention to retracements because a) they are a failsafe mechanism that permits bears or bulls that overstay to call it quits and b) frequently, they provide an ideal selling or buying point that parallels the main trend and runs counter to the intermediate trend.

The axiom runs as follows (more or less): Markets are "entitled" to retrace 50% of their prior move (this is as true for intraday as for multiyear fluctuations). Furthermore, they are "permitted" to retrace up to two thirds of their previous move without forcing the trader to reconsider his position. A retracement beyond two thirds of the previous move would constitute a change in trend, and our trend-following trader would be wise to go along with the new trend. The writer admits that he has never tested *empirically* this statement but recalls enough situations where the application of such a rule ended in a successful trade.

Let us next turn to the US stock market. We compute the difference between the high (2736.6) and subsequent low (1711.7) of the Dow Jones Industrial Average, multiply the difference by .666, and obtain 682.58. We then add this number to the low (1711.7) and obtain 2394.3. In effect, a full two-thirds retracement of the Dow Jones Industrial Average would take it to 2394.3. Last week's intraday's high was 2361. At the close of the week, the DJIA settled at 2324. Close, but no cigar.

Repeating the exercise for the S&P 500 (high 337.89, low 216.47), we estimate that the two-thirds retracement level stands at 297.33. Here, the market exceeded the exact retracement level by a little under 300 points but only for two days. At the close of *that* week, it settled at 292.02, and at the close of this week it settled at 296.75. Finally, the same exercise for the broad Value Line Index yields a two-thirds retracement level at 252.88. The recent high was 247.81, and at week's end it settled at 247.26 (old index).

What it all means is that it is still too early to be calling for a new bull market. In fact, short sales (or put purchases) at these levels carry a *measured but small risk*.

This rally, unlike the previous three attempts during 1988, succeeded in bringing back the institutional investor and *some* retail investors into the market. The Crash has all but been forgotten, Morgan Stanley is back into program trading, "story" stocks have joined takeover and LBO deals, and the odd-lot shortseller has been so devastated that he no longer remembers his broker's phone number.

For the first time in as long as an option trader can remember (they compete with elephants for the prize), the two-week CBOE Composite Put Index traded at a mere 70.7% of the Composite Call Index, an indication that bullishness was rampant in the option pits. Finally, *Investors Intelligence* reports that again for the first time in many months, there were more bulls (43.6%) than bears (37.3%) last week. Ah, but for rising prices....

To top it off, General Motors declared a two for one split, the first since 1955 and a 20% dividend boost on its common shares, days before GM's car sales are reported to be down 20.2% from a year ago!

The herd, irrational instinct was back on Wall Street: Jean-Claude Gruet of Salomon Brothers raised his 1989 earnings estimate to $17/share from $12.50/share and changed his rating on the stock to "buy" from "hold," saying: "My position had been that weakening auto sales, questionable market share, continued incentives, and direct cost increases would more than offset the restructuring benefits... my position now is that I believe the reverse." Another analyst, Philip K. Fricks of Prudential-Bache, had this (brilliant statement) to make: "Clearly the dividend increase *sends a message* (italics ours) to investors that (GM) can sustain a relatively high level of earnings." As if the GM chairman was a prophet. And we thought that splits and dividend increases were supposed to suck in only the unsophisticated investor! One week later, GM was trading 6½% lower.

We are impressed by the rise in the bullish consensus. And even more impressed that it happens to coincide with the two-thirds retracement level, a most difficult level to overcome. Then, of course, there are the fundamentals — a possible soft landing that leads to a certain hard landing (see opening comments).

STRATEGY: *You're long March 270 puts (now almost worthless) and June 295 S&P 500 puts. You're short outright June '89 futures, at around* 303.00, *with stops at 306.50, good anytime.*

Retain long March '89 S&P/short March '89 Value Line spread. We were stopped out of long 3 March '89 T-bonds/short 2 March '89 S&P.

Chart 6
S&P 500 JULY 1, 1987 to FEB. 17, 1989

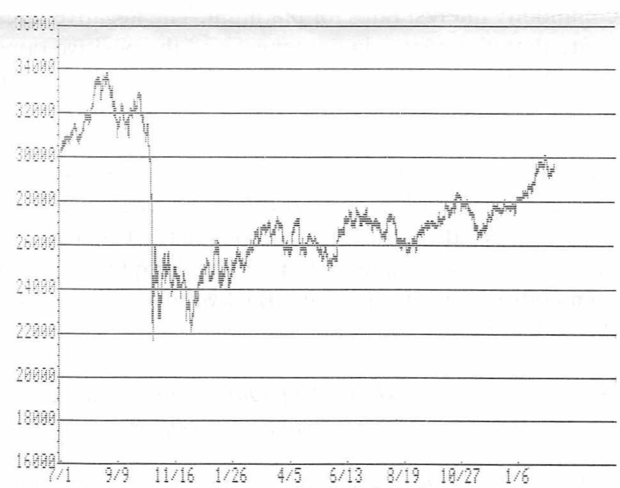
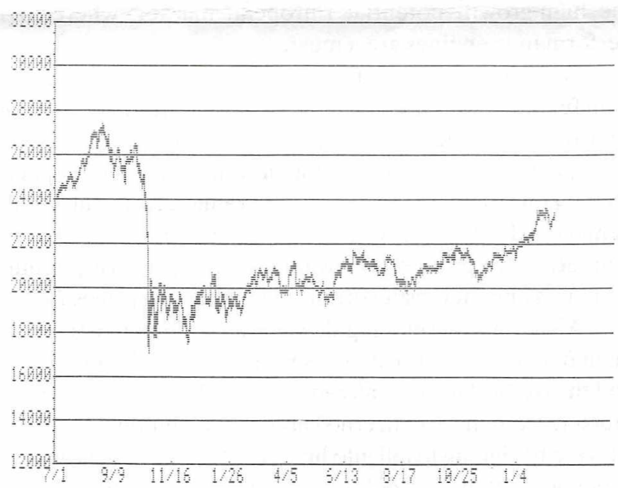


Chart 7
DOW JONES INDUSTRIAL INDEX
JULY 1/89 - FEB. 17/89



CURRENCIES

Creeping fix-ation

We have been dollar bulls because we've felt that a) the dollar, in real terms, was priced fairly (and perhaps a bit undervalued), and b) capital inflows into the US were helping to sustain the dollar and were the primary cause of the current account deficit. So long as these capital flows remained favorable to the US, the dollar would bounce up. Dollar bashing (by talking it down, as in 1985-87) and/or a recession would dry up these flows and put downward pressure on the dollar.

Anticipating *some* weakness in the economy (as explained in our opening articles), we've accepted profits on our long US dollar positions and even moved, on a 'trading' basis (translated to mean that we could be reversing on a dime whenever the weakness-in-the-economy perception disappears) to the short side. Almost invariably, we're moving towards a fixed or semi-fixed exchange regime bound perhaps by Yen 119-131 and DM 1.70-1.90. In effect, this means that 1) the *big moves* will be on the interest rate front (à la EMS) and 2) one has to become increasingly nimble to extract a pound.

STRATEGY: *As per flash update of Feb. 16, we are long March '89 yen, March '89 DM, March '89 SF, and March '89 BP with stops at 79.00, 54.00, 63.50, 175.00 respectively, close only.*

PLATINUM

Asserting its independence

The Ford Motor Company's December announcement that it had developed a non-platinum autocatalyst brought an abrupt reversal in what had been a surge in platinum prices (see Chart 15). Since then, the Ford story has begun to lose its punch, and prices have begun to recover.

Although Ford hasn't said so, most speculate that the autocatalyst that it is testing is made of palladium. This type of catalyst can be satisfactorily used only on low-compression engines. At least that is what the folks at Toyota tell us. Toyota has worked with palladium autocatalysts, and it has found that these catalysts are inadequate in high-compression (high-temperature) engines, because palladium catalysts break down at high temperatures. This means that even if they were available, the palladium autocatalysts would not be suited for the high-growth potential European market, where high-performance engines are a must.

With the Ford story fading fast, it is clear that the platinum fundamentals about which we have written over the past year remain sound. On the supply side, mines are operating at capacity, and prospects for additions to new capacity coming on stream in the near future remain doubtful. On the demand side, Japan continues to take the lion's share of the market, slowing its offtake when the yen price of platinum increases and increasing offtake when the yen prices falls.

Also, while developing slower than anticipated, the European demand for autocatalysts is picking up. West Germany and the Netherlands are already on board, and with mounting pressure from those concerned about air pollution, other countries are beginning to fall into line. As a leading indicator of the expectation that auto pollution control devices (hence, autocatalysts) are on their way, it is interesting to note that the number of gasoline stations in Britain that offer unleaded gasoline (required with pollution control devices) has risen from near zero several months ago to eight percent of the total.

Chart 15 contains data that confirm platinum's strong fundamentals. As we discussed in an accompanying article about the economy, long-bond yields have remained steady, indicating that there has been virtually no build-up in inflation expectations. This is confirmed, in part, by the fact that gold prices have been falling (see Column 2). However, platinum prices, without the aid of heightened inflation expectations, have been moving up (see Column 1). In consequence of platinum's price rise and gold's price decline, the platinum-gold spread (see Column 1-2) has risen to a relatively high level.

That the move in platinum prices is the result of a relative physical scarcity can be seen by observing the trend in commodity interest rates for platinum. The negative rates indicate that platinum is in contango, and the positive rates indicate backwardation. The interesting feature in the platinum market is that it moved, late last November, from being in contango to being in backwardation, indicating some degree of physical scarcity. Recall that with positive commodity interest rates, the market generates an incentive for platinum to be lent from the future to the spot market, where the relative scarcity is occurring. (For a more complete analysis of commodity interest rates see: "Backwardation revisited," *FC&CC* Dec. 20, 1987.)

STRATEGY: *As per the flash update of Feb. 7, you are long April '89 platinum (at approximately 530.00). Raise stops to 509.00, close only.*

Risk averse traders may wish to establish a spread of long 2 July '89 platinum/short 1 June '89 gold.

– Dr. Steve H. Hanke

Chart 15 – PLATINUM

Week Ending	(1) Platinum Price *	(2) Gold Price *	(1 - 2) Spread	Platinum's Commodity Interest Rate
2/18/89	548.80	380.80	168.00	0.78 %
2/12	525.00	388.80	136.20	0.49
2/5	523.20	393.10	130.10	0.43
1/29	517.40	396.10	121.30	0.00
1/22	546.10	409.30	136.80	2.07
1/15	521.00	403.50	117.50	0.33
1/8	521.90	408.10	113.80	0.16
1/1	515.60	412.30	103.30	0.33
12/25/88	540.10	421.60	118.50	0.80
12/18	554.50	414.00	140.50	2.51
12/4	615.90	431.70	184.20	4.13
11/27	571.00	420.10	150.90	0.06
11/20	558.40	418.10	140.30	-0.31
11/13	581.60	423.10	158.50	0.86
11/6	580.60	423.50	157.10	-0.09
10/30	543.80	441.10	102.70	-1.25
10/23	527.90	411.50	116.40	-2.34
10/16	529.20	412.50	116.70	-3.02
10/9	509.60	407.30	102.30	-1.00
10/2	498.50	394.40	104.10	-3.37
9/25	480.90	394.80	86.10	-2.91
9/18	515.40	412.90	102.50	-2.78
9/11	525.80	423.10	102.70	-3.20
9/4	523.50	431.80	91.70	-3.53
8/28	542.20	435.60	106.60	-3.07
8/21	534.70	435.60	99.10	-4.07
8/14	531.00	431.30	99.70	-4.10
8/7	539.00	432.30	106.70	-3.98
7/31	528.80	436.10	92.70	-4.45
7/24	562.70	442.90	119.80	-3.87
7/17	554.30	441.30	113.00	-3.93
7/10	577.30	441.00	136.30	-4.14
7/3	568.20	439.60	128.60	-4.12
6/26	555.80	446.00	109.80	-3.48
6/19	589.20	458.30	130.90	-3.64
6/12	572.90	449.10	123.80	-4.09
6/5	610.60	464.80	145.80	-3.71
5/29	585.90	450.80	135.10	-3.58
5/22	568.60	458.70	109.90	-3.22
5/15	550.30	453.70	96.60	-3.21
5/8	526.60	445.30	81.30	-3.82
5/1	525.10	452.60	72.50	-3.99
4/24	521.80	450.90	70.90	-4.01
4/17	543.40	455.90	87.50	-3.64
4/10	536.60	451.60	85.00	-3.38
4/3	530.70	454.40	76.30	-2.86
3/27	503.10	453.30	49.80	-3.21
3/20	497.30	444.30	53.00	-3.21

* Most active near term contract

GOLD/SILVER

Don't disturb the bear

Although gold continues to lose ground *vis à vis* the CRB and silver (and platinum, see story); it has become quite oversold. As a result, a substantial rally looks imminent. Nevertheless, we would *not* disturb present bear spreads.

STRATEGY: *We remain short 4 December '89 gold/long 5 December '89 silver, now showing handsome profits (see Chart 16). Also, we retain the highly profitable long 2 CRB/short 7 gold spread (see Chart 17).*

Chart 16 – DEC. GOLD/DEC. SILVER

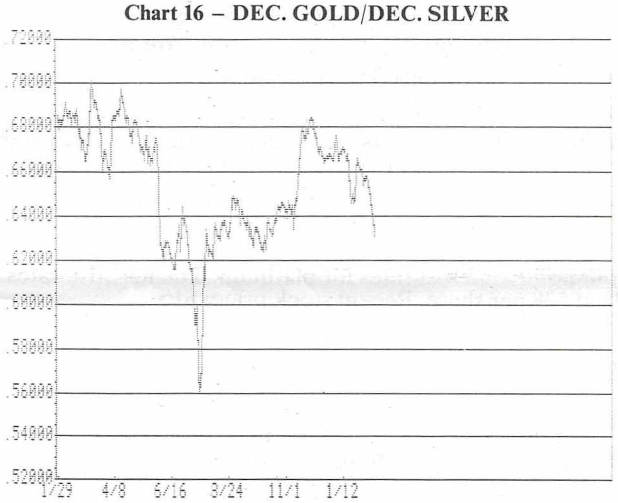
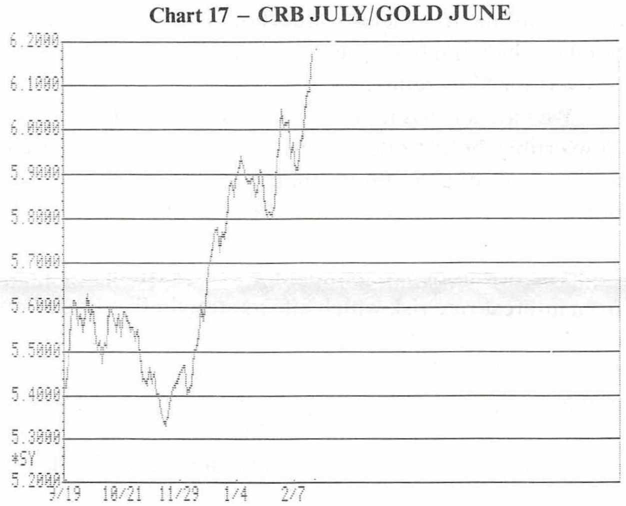


Chart 17 – CRB JULY/GOLD JUNE



SUGAR

The long road to profit

Long, stopped out, and finally long again at 10.05, basis May '89 (see Feb. 3 Hotline). Good positions cost money (and aggravation) before one can see them through.

STRATEGY: *Remain long, raise stops to 10.75, close only.*

WHEAT

Stay the course

We are confident that the fundamentals remain in place for a strong run-up in wheat prices. Here are the elements:

(1) Current stock levels are relatively low.

(2) Although export sales have been rather slow of late, we anticipate that the Bush Administration will announce that more wheat qualifies for the EEP in the coming weeks.

(3) China, the Soviets, Egypt, etc. will purchase wheat under the EEP.

(4) These purchases will further dent current stocks, resulting in a very low carryover for wheat stocks.

(5) These low carryovers will probably not be sufficiently augmented by new winter wheat supplies. Although it might be a bit premature to call for a poor winter wheat crop (wheat is basically a rather tough weed that can take some punishment), there are signs that the crop is encountering some problems. The dry (sparse snow cover), cold winter weather has created a less than ideal situation for the winter crop.

As a real indicator of these problems, consider that there has been an unusually large placement of young cattle in feedlots. For example, the number in January is up 3% from last January. This is a 15-year high for January. In addition, placements in Kansas, a big winter wheat state, were up in January by 31% over a year earlier. These increased placements are, in large part, the result of the fact that the winter wheat crop is in such poor condition that it will not accommodate normal winter grazing. In consequence, without adequate feed from winter wheat, ranchers have had to increase their placements to feedlots.

Wheat is poised for a sharp price run up.

STRATEGY: *Long May '89, with stops at 4.16, close only.*

– Dr. Steve H. Hanke

FRIEDBERG CAPITAL MARKETS

Since the inception of Friedberg Capital Markets, we have tried to keep abreast of exciting new opportunities available in various financial markets. Our list of products is expanding as we continue to seek out value, both from foreign currency bond markets and financial instruments that might otherwise be overlooked by retail investors.

We have started to deal in the convertible bond market. Convertible bonds offer investors a fixed rate of interest, which represents a "floor" that provides downside protection and current income, while the conversion feature offers participation in stock price appreciation.

The downside risk of holding a convertible bond, aside from interest-rate risk which affects straight fixed-rate bonds as well as convertibles, is that the underlying stock price falls to a level that the exercise of the conversion privilege becomes an unlikely possibility. In this case, the convertible would lose its premium and decline to a price that yields a return similar to "straight" (without the conversion feature) bonds with similar ratings and maturities. This price is referred to as the "investment value" of the bond.

We try to find convertible bonds that trade close to their investment values, in the process paying little or almost nothing for the privilege of conversion. We are currently offering the following convertible bond:

Pacific Scientific 7¾% (semi-annual) 15/06/03, priced at 69, to yield 12.82%. Rated BA3 by Moody's. Traded in the US over-the-counter market and listed on the NYSE.

Conversion terms: 26.32 shares per $1,000 bond or convertible at $38 per share. Recent stock price: $15.

Investment value: 63

Fixed charges coverage far superior to popular junk bonds, while paying almost nothing for a 14-year call option.

Chart 20

Recommended bond portfolio allocation:

New Zealand dollar bonds	15%
US dollar floaters	85%

Chart 21

FOREIGN CURRENCY BONDS

Date: February 16, 1989

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 1/4	105	12.77	02/04/88-02/04/89
SALLIE MAE (semi annual) 04/08/90 17%	104 1/2	105 1/4	13.30	04/02/89-04/08/89
MCDONALD'S (semi annual) 15/08/90 16 3/4%	104 3/8	105 1/8	13.24	15/02/89-15/08/90
TOURIST HOTEL (N.Z.) 04/06/93 zero coupon	56 1/4	57 3/4	13.69	matures 04/06/93
AUSTRALIAN DOLLAR DENOMINATED BONDS				
COMMONWEALTH BANK OF AUSTRALIA 01/07/94 14%	95 1/8	95 7/8	15.11	01/07/88-01/07/89
WORLD BANK 15/03/93 12 3/4% RRSP eligible	91 1/4	92	15.53	15/03/88-15/03/89
CAN.IMP.BANK OF COMMERCE 13/03/91 13% RRSP eligible	92	-	-	13/03/88-13/03/89
DANISH KRONE DENOMINATED BONDS				
WORLD BANK 20/11/92 9 3/4% RRSP eligible	100 3/8		-	20/11/88-20/11/89
STOCKHOLM 10/11/91 10 5/8%	102 1/4	103 1/4	9.18	10/11/88-10/11/89
BRITISH POUND DENOMINATED BONDS				
KGDM of SWEDEN 14/4/93 9 3/8%	96 1/4	97	10.28	14/04/88-14-04/89
DEUTSCHE MARK DENOMINATED BONDS				
QUEBEC HYDRO 1/5/96 5 1/2 RRSP eligible	94 1/8	94 7/8	6.41	01/05/88-01/05/89
SWISS FRANC DENOMINATED BONDS				
GOVT.OF AUSTRALIA 30/10/98 5%	97 1/2	98 1/4	5.23	30/11/88-30/10/89
JAPANESE YEN DENOMINATED BONDS				
GOVT.OF CANADA 23/7/93 5 5/8% RRSP eligible	102 7/8	103 5/8	4.69	23/07/88-23/07/89
U.S.DOLLAR DENOMINATED FIXED CONVERTIBLE BONDS				
PACIFIC SCIENTIFIC 7 3/4% (semi ann.) 15/06/03 CV Sh's per $1000 bond 26.32 @$38 p/sh.	67½	69	12.82	15/12/88-15/06/89
U.S.DOLLAR DENOMINATED FIXED RATE BONDS				
ALBERTA 9/12/91 7 3/8% RRSP eligible	93 7/8	94 5/8	9.64	9/12/88-9/12/89

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	9 1/8		28/12/88-28/03/89
REPUBLIC OF ITALY 30/4/93 3 mo Limean (quarterly)	98.95- 99.35	9 3/8		31/01/89-28/04/89
REPUBLIC OF PORTUGAL 8/12/93 (semi annual) 6 mo LIBOR +5 B.P.	99.52- 99.82	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)	61 -63½	10 11/16 *	16.8%	20/01/89-20/01/90
ARGENTINA 15/2/92 BONEX ser.82 LIBOR (sem.ann.)	.7525-.7650	TBA **	22.66%	15/02/89-15/08/90 amortized:12½% of principal paid yearly

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

Chart 22
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 FEBRUARY 16/89.**

	U.S. $	NEW ZEALAND $	AUSTRALIAN $	DEUTSCHEMARK	SWISS FRANC	JAPANESE YEN	DANISH KRONE
1 year	9.24%	McDonalds 16¾% 15/8/90 Yields 13.24% (.592 NZ/US)**					
2 year	9.33%						Stockholm 10⅝% 10/11/91 yields 9.18% (7.14 Dkr/US)
4 year	9.31%	Tourist Hotel 0% 4/6/93 Yields 13.69% (.524 NZ/US)	World Bank 12¾ 15/3/93 Yields 15.53% (.779 A$/US)			Canada 5⅝% 23/7/93 Yields 4.72% (101.68 US/JY)	
5 year	9.30%						
6 year	9.26%						
7 year	9.24%			Quebec Hydro 5½ 1/5/96 yields 6.41% (1.53 US/DM)			
10 year	9.19%				Australia 5% 30/10/98 yields 5.23% (1.08 US/SF)		
Spot Exchange Rate	N/A	61.35	.8410	1.8414	1.5642	126.35	7.1645

**For example, in parentheses, since a US$ based investor would receive 400 basis points (1324-924) by holding the McDonalds 16¾% bond, NZ$ can depreciate to .592 NZ/US from the present spot exchange rate of .6135 NZ/US over the next 1 year for the NZ$ investment to break even with current US$ rates of interest. Assumes that bonds are held to maturity, and coupons are reinvested.

THE EXOTICS

New Zealand dollar

The magic is gone.

Roger Douglas, New Zealand's Finance Minister and architect of one of the most dramatic liberalization programs anywhere in the globe was unceremoniously dumped by Premiere Lange, culminating a long-standing personal and ideological feud. Shortly thereafter most of the Douglas men in the cabinet were removed, as the labor government took a serious lurch to the left.

The fragile reforms of the past four years can be dismantled quite easily, especially considering the present economic environment. New Zealand was put through a heart-wrenching economic adjustment that by necessity had to seriously impact living standards.

That the adjustment was becoming successful is evident from the sharp turn in the external accounts: the current account deficit dropped from 7.5% of GNP in 1986 to less than 1% of GNP in 1988; the equally sharp drop in the inflation rate from 18.2% in 1986 to 4.7% in 1988; and the dramatic improvement in the fiscal budget from a deficit of 9% of GDP in 1983-84 to an estimated surplus of 3.6% of GDP in 1988-89.

The population as well as the business community is visibly tired of the adjustment process and are pressing for reflationary measures, which include lower interest rates and a lower exchange rate for the New Zealand dollar. Without a strong and ideologically committed general at the helm of the government, the Labor party is likely to cave in to these and other demands, such as a slowing to privatization efforts.

Clearly, the miracle is over. The Kiwi turnaround that we proudly and assuredly heralded in *our comments of May 1986* has been *at the very least* put off course, and may have to wait until the next election (that is, if the National Party has learned its lessons, or in the unlikely event that Roger Douglas captures the premiership of the Labor party).

With five-year New Zealand government debt instruments yielding only 400 basis points more than US treasuries, down from the extraordinary 1200 basis-point differential in early 1986, the advantages of holding New Zealand bonds have diminished considerably.

STRATEGY: *We are recommending a lowering of our exposures to New Zealand in a diversified bond portfolio to 15% from 40%. Furthermore, we believe that the best New Zealand dollar bond is Tourist Hotel June 1993 zero coupon bond, which may benefit from an easier monetary policy and somewhat offset any possible downward tendencies in the currency.*

Liquidate all long forward positions. Remain neutral against both the US dollar and DM.

Chart 23

YEAR	NEW ZEALAND DOLLAR PER U.S. DOLLAR (PERIOD End)	U.S. 1970 =1.00	U.S. 1978 =1.00	AUSTRALIA 100% 1970 =1.00	AUSTRALIA 100% 1978 =1.00
1967	1.3554	0.8253	1.1096	0.8737	0.8582
1968	1.1170	1.0019	1.3470	1.0450	1.0264
1969	1.1152	1.0071	1.3541	1.0234	1.0052
1970	1.1193	1.0000	1.3445	1.0000	0.9823
1971	1.1416	0.9232	1.2412	0.9568	0.9399
1972	1.1952	0.8547	1.1491	0.9510	0.9341
1973	1.3615	0.7354	0.9888	1.0063	0.9884
1974	1.4004	0.7136	0.9594	1.0260	1.0078
1975	1.2157	0.7847	1.0551	1.0830	1.0638
1976	0.9963	0.8663	1.1647	1.1997	1.1784
1977	0.9708	0.8270	1.1119	1.0922	1.0729
1978	1.0378	0.7438	1.0000	1.0181	1.0000
1979	1.0229	0.7390	0.9936	0.9680	0.9509
1980	0.9742	0.7513	1.0101	0.9733	0.9561
1981	0.8700	0.8048	1.0821	1.0487	1.0301
1982	0.7519	0.8507	1.1437	1.0251	1.0069
1983	0.6688	0.9195	1.2362	1.0455	1.0270
1984	0.5785	1.0448	1.4048	1.1600	1.1394
1985	0.4984	1.0879	1.4627	0.9889	0.9713
1986	0.5253	0.9292	1.2492	0.8626	0.8473
1987	0.5922	0.7763	1.0438	0.7890	0.7750
1988 (1Q)	0.6621	0.6423	0.8636	0.6862	0.6740
1988 (2Q)	0.6834	0.6249	0.8402	0.7254	0.7125
1988 (3Q)	0.6449	0.6720	0.9034	0.7990	0.7848

FOREX RATES & UPDATE

Currency	*Spot*	*3-Month*	*12-Month*	*Comments vis à vis ~~DM~~*	*Comments vis à vis DM (Spot DM: 1.8400)*
Australian dollar	.8220-.8240	.8080-.8105	.7690-.7725	~~Neutral~~	Neutral
Belgian franc	38.47-38.57	38.30-38.42	37.67-37.97	Remain long**	Neutral
Danish krone	7.13-7.14	7.10-7.11	7.02-7.04	Remain long**	Neutral
Dutch guilder	2.0715-2.0725	2.0570-2.0585	2.0100-2.0120	Remain long**	Neutral
Greek drachma	153.70-153.70	154.90-156.90	161.10-169.25	Remain short	Remain short
*Hong Kong dollar	7.8010-7.8020	7.7980-7.8025	7.7880-7.8000	Neutral	~~Liquidate~~ N
Irish punt	1.4510-1.4540	Not available	Not available	Remain long**	Neutral
Italian lira	1342-1344	1349-1351	1370-1376	Remain long**	Neutral
Kuwaiti dinar	.28700-.28740	.28580-.28640	.28100-.28280	Remain short	Neutral
Malaysian ringgit	2.7250-2.7280	2.7125-2.7225	2.6780-2.7000	Neutral	Neutral
*New Zealand dollar	.6145-.6165	.6090-.6120	.5945-.6005	Neutral	Neutral
Norwegian krone	6.66-6.67	6.62-6.64	6.70-6.72	Neutral	Neutral
Portugese escudo	150.50-150.90	150.90-152.00	153.50-157.90	Neutral	Remain long
Saudi Arabian riyal	3.7500-3.7510	3.7490-3.7515	3.7475-3.7515	Remain short	Remain short
*Singapore dollar	1.9200-1.9210	1.9025-1.9050	1.8510-1.8610	Remain long	~~Liquidate~~
*Spanish peseta	114.10-114.20	114.90-115.10	117.40-117.90	Liquidate	Neutral
*Swedish krona	6.27-6.28	6.28-6.29	6.29-6.31	Liquidate	Neutral

Explanatory Notes

*Indicates change in recommendation from last issue.		
**Denotes change as per Hotline Update of February 16		
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

Flash update, Tuesday, January 24, 2:05 p.m.: Reinstate immediately full long US$ positions at market, by selling JY, SF, DM, and other EMS currencies. Stay posted for new stops. The market letter is in the mail.

Flash update, Wednesday, January 25, 9:30 a.m.: Sell long copper positions at market, accepting profits.

Wednesday, January 25:

1) As of this morning's flash update, we have liquidated long copper positions at market, accepting profits.
2) As of Tuesday morning's flash update, we have reinstated long US$ positions by selling JY, SF, DM, and other EMS currencies.

Friday, January 27:

1) As of Wednesday's flash update at 9:30 a.m., we liquidated long copper positions at market, accepting profits.
2) As of Tuesday's flash update, we are once again long the dollar. Place protective stops on short March JY, March DM, and March SF at 7970, 5550, and 6530 respectively, close only. For other EMS currencies, follow the DM.

Tuesday, January 31: One recommendation: Roll long March soymeal contracts to December.

Friday, February 3:

1) Buy May sugar at 1005 or better.
2) As per Tuesday's update, roll over long March soymeal contracts to December.

Flash update, Thursday, February 7, 8:30 a.m.:

1) Buy April platinum at market, risking 499.00, close only.
2) You are long May sugar at 1005 as per our Friday recommendation. Place initial stops at 925, good anytime.

Thursday, February 9:

Two messages:

1) There is an excellent chance that the stock market rally begun in November '88 is coming to an end, representing the culmination of a long bear market rally that retraced approximately two thirds of the entire August/November 1987 decline.

   If so, there is only limited risk in selling June '89 S&P at market, placing stops at 306.50, good anytime. Alternatively, buy June 295 puts at market.
2) Liquidate all long US dollar positions at market. We are temporarily stepping aside. Keep in touch.

Friday, February 10: A wrapup of the week's activities. As per our flash of Tuesday, February 7:

1) We are long April platinum, risking 499.00, close only.
2) We are long May sugar at 1005, raising stops to 940, close only.

As per our flash of February 9:

1) We have liquidated all long US$ positions, stepping aside. Keep in touch.
2) We have added to our S&P put positions by purchasing June 295 put options, and we have sold outright June S&P at around 303.00, placing stops at 30650, good anytime.

Tuesday, February 14: There are no changes or new recommendations.

Flash update, Thursday, February 16: As you know, we liquidated long US$ positions as per our flash update on Thursday, February 9. We would now like to establish a short position in the US$, which at this time may just be a trading affair, fully aware that tomorrow the US releases its merchandise trade figures.

Buy March Yen, DM, SF, BP and other EMS currencies at market. Stops will be on the tape tomorrow.

Friday, February 17: A recap of the changes and additions to outstanding positions since the last market letter:

1) We have sold long copper positions, accepting handsome profits (145.50 basis March).
2) We have rolled over long March soymeal positions to December.
3) We are long May sugar at 1005 with stops at 1025, close only.
4) We are long April platinum at 531.00 with stops at 499.00, close only.
5) We are short June S&P with stops at 30650, good anytime. We are long June 295 S&P put options.
6) We are long currencies: Yen, DM, SF, BP, and other EMS currencies. Place initial stops at 79.00, 54.00, 63.50, 175.00 respectively basis March, close only.

Friedberg's Commodity & Currency Comments (ISSN 0229-4559) is published monthly by Friedberg Commodity Management Inc., 347 Bay Street, Toronto, Ontario, M5H 2R7.

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