

FRIEDBERG'S

COMMODITY & CURRENCY COMMENTS

Friedberg Commodity Management Inc.



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US-Canadian "yield curve" equations

In our July 1987 piece, "Forecasters versus the markets," we concluded that the information contained in market prices reveals more about the future than that included in professional forecasts. In other words, market participants, who put their own wealth at risk, do a better job of anticipating the future course of the economy than do professional forecasters.

Given this conclusion, the question is: Should we use stock or bond prices to predict the future course of the economy? Equity prices have had a large following as leading indicators of real economic activity. Indeed, they (the S&P Composite Index) are the only prices contained in the US Department of Commerce's index of leading indicators.

However, many have begun to question the efficacy of using stock prices to forecast economic activity. The skeptics note that stock prices emit too many false signals. Hence, many conclude that equity prices are of limited use. To support their case, the skeptics point to the October 1987 stock-market crash and the fact that an economic slowdown in 1988 never occurred. In addition, they argue that the 1961 to 1988 period produced nine troughs in the year-to-year change in S&P 500, but only four recessions were recorded.

Recent research shows that prices in the bond market contain more reliable information about economic growth than do stock prices. What is more, forecasts that use information contained in bond prices are superior to forecasts made by the commercial, econometric, forecasting services. Hence, the validity of our conclusion that markets are superior to professional forecasters.

The reliable yield curve

The specific price relationship that has been shown to be a superior forecasting tool is the yield curve, which measures the difference between long-term and short-term interest rates. When short-term rates are below long-term rates, spreads are positive, yield curves are positively sloped, and market participants anticipate an economic expansion. Alternatively, a negative yield curve (spread) precedes an economic slowdown or recession. Indeed, when measured by the difference between the 10-year and three-month yield on government bonds, the spread became negative in 1969, 1973, 1979, and 1981. Hence, these negative spreads anticipated

each of the last four recessions.

The theory behind the relationship between the interest rate spread and real economic activity was first developed in 1907 by Professor Irving Fisher. In that year, Professor Fisher, who ranks as one of the greatest economists that America has produced, published his classic treatise, *The Rate of Interest*. Building on Professor Fisher's insights, modern economists have refined and tested his theory. For example, Dr. Campbell R. Harvey, a native of Toronto and Ph.D. from the University of Chicago, has produced an impressive set of research papers about the Fisherian theory.

Dr. Harvey suggests that investors receive more benefit from a dollar when their consumption levels are "low" (during a slowdown or a recession) than from a dollar when their consumption levels are "high" (during the peak of a business cycle). In consequence, if investors anticipate an economic downturn, they will tend to sacrifice current income (during "good" times) in exchange for future income (during "bad" times). In other words, during good times, investors will tend to invest in assets that will provide insurance for an expected downturn in the economy.

This investment hedging behavior is intended to allow investors to smooth their consumption over time. It also implies that in anticipation of an economic slowdown, investors will tend to sell some of their short-term bonds and substitute longer-term bonds that will generate income dur-

In this issue

The PPP phoenix rises from the ashes; the yen/DM cross; we add to the short side of oil with puts; sidelined in the stock market; Is gold bottoming? Also Greek and Australian exotics. Contributions by Albert D. Friedberg, Dr. Steve H. Hanke, Daniel A. Gordon, Michael D. Hart, and Brian Baker.

Special Note

We will not publish an issue in August. The next issue will be published in September. Call the Hotline for updates in the meantime.

ing an anticipated economic slowdown. This will cause the price for short-term bonds to be bid down, which will cause their yields to rise, and the price for longer-term bonds to be bid up, which will cause their yields to fall. In other words, an anticipated economic downturn will cause a "normal," positively-sloped yield curve to become flatter or invert. Just how much substitution between short-term and long-term bonds takes place (the magnitude of the bond price and yield movements) will depend on the strength of investors' expectations about the future course of the economy.

In conclusion, the Fisherian theory of interest spreads implies that current interest rate spreads contain information about expected economic growth. In consequence, this information should be able to be used to forecast the course of the economy.

Theory and practice

So much for the theory. Do the data support it? To answer this question, we rely on Dr. Harvey's studies of the U.S. and Canadian economies and their bond markets. Dr. Harvey has estimated "yield curve" equations for the US and Canada. These equations are based on 53 quarterly observations from 1976:1 to 1989:1.

For the US, two yield spreads are used to estimate two equations: the five-year government bond yield minus the three-month Treasury bill rate and the 10-year government bond yield minus the three-month Treasury bill rate. For Canada, one yield spread is used to estimate one equation: the 10-year government bond yield minus the three-month Treasury bill rate. The equations are displayed in Chart 1.

Before we forecast economic growth in the US and Canada, we should mention that equations (1) and (2) account for 44% and 45% of the changes in the US real GNP one year ahead, respectively, and equation (3) accounts for 43% of the changes in the Canadian real GNP one year ahead. This level of explanatory power is significantly greater than that obtained by modelling stock prices in New York and Toronto. Moreover, over the period 1976:1 to 1989:1, the yield curve equations perform better than the seven leading

commercial forecasting services.

To forecast economic activity for the period 1988:3 to 1990:3, we must obtain only the average interest rates for the most recent quarter (April to June) and insert them into the relevant equations.

For example, let's work through the Canadian forecast. The average 10-year yield on government bonds for April to June was 0.0985, and the three-month Treasury bill rate was 0.1234. If we add 1.0 to each of these numbers and divide the former by the latter (1.0985/1.1234), we obtain 0.9778. Next, we must take the natural logarithm (\ln) times 0.9778 because we are forecasting a continuous rate of growth for real GNP. The result of this multiplication equals -0.0225, which is inserted into equation (3a).

Note that the value of -0.0225 can be roughly interpreted as a -225 basis-point difference between the 10-year bond yield and the three-month Treasury bill rate. If we then perform relevant operations defined in equation (3a), we obtain the growth rate for the Canadian economy for the period 1989:3 to 1990:3 of -0.3%. If we perform the same operations for the US, we obtain economic growth rates of +1.7% with equation (1a) and +1.6% with equation (2a).

In conclusion, the yield curve equations (the markets and the mild, negative yield spreads) forecast a slowdown, but no recession, for the US economy. This is consistent with the views that we have expressed for many months. The picture is not as rosy for Canada. The market expectations, which are incorporated into the rather large negative yield spread, show that the Canadian economy is expected to fall into a mild recession.

STRATEGY: *The anticipated downturn in the Canadian economy will result in a mild recession. In consequence, the Bank of Canada will be forced to loosen monetary policy and allow short rates to fall. When this occurs, the Canadian dollar will come under heavy downward pressure. Add to previously-purchased out-of-the-money, one-year put options. They are extremely cheap.*

– Dr. Steve H. Hanke

Chart 1 – "Yield Curve" Equations

UNITED STATES	
	Five-Year Yield Curve
(1)	$\Delta \text{GNP next year} = 0.020 + \left[1.271 \times \ln \left(\frac{\$1 + \text{five-year yield}}{\$1 + \text{three-month rate}} \right) \right]$
(1a)	$\Delta \text{GNP 1989:3-1990:3} = 0.020 + [1.271 \times -0.002137] = +1.7\%$
	10-Year Yield Curve
(2)	$\Delta \text{GNP next year} = 0.019 + \left[1.118 \times \ln \left(\frac{\$1 + 10\text{-year yield}}{\$1 + \text{three-month rate}} \right) \right]$
(2a)	$\Delta \text{GNP 1989:3-1990:3} = 0.019 + [1.118 \times -0.002842] = +1.6\%$
CANADA	
	10-Year Yield Curve
(3)	$\Delta \text{GNP next year} = 0.026 + \left[1.2738 \times \ln \left(\frac{\$1 + 10\text{-year yield}}{\$1 + \text{three-month rate}} \right) \right]$
(3a)	$\Delta \text{GNP 1989:3-1990:3} = 0.026 + [1.2738 \times -0.0225] = -0.3\%$

CURRENCY**The PPP phoenix**

For some time we have asserted that the dollar is “undervalued.” Indeed, we never thought the dollar was “overvalued,” even when it hit its February 1985 peak. What’s going on here? Don’t markets determine a currency’s value, and if so, how can we assert that a currency is either “undervalued” or “overvalued”? To do this, we must have a reference point. Purchasing power parity (PPP) is such a reference point.

Although there are several versions of PPP, we simply present the general concept, since this is satisfactory for our purposes. PPP is sometimes referred to as the law of one price because it implies that the price of a common basket of goods in any two countries should be equal, when measured in a common currency.

The law of one price should be enforced by international arbitrage. For example, if a ton of steel is selling at a lower price in Japan than in the US, international arbitrage would profit from purchasing steel in Japan and selling it in the US. The increased demand in Japan would cause the price of steel in Japan to increase and the increased supply in the US would cause the price of steel in the US to decline. In addition, the increased demand for Japanese goods would cause the value of the yen to rise relative to the dollar. These changes would continue until a ton of steel in Japan and the US had identical prices in either yen or dollar terms.

Given the PPP theory, market exchange rates should equal their PPP rates. Hence, if the market value of the dollar is under its PPP value, we can conclude that the dollar is “undervalued.” The dollar is “overvalued” when its market value exceeds its PPP value.

The disfunctioning PPP

Do the data support the PPP theory? In the short run they do not. Indeed, evidence shows that there can be rather large deviations of market rates from PPP. For example, Professor Ronald McKinnon, the leading authority on PPP, estimates that the current PPP rates are 175 yen/\$ and 2.08 DM/\$. This means that the dollar is about 19% “undervalued” against the yen and about 8% “undervalued” against the DM. In the short-run, therefore, the PPP theory doesn’t work.

There are several reasons that explain the short-run disfunctioning of PPP:

- Some items cannot be traded and are not subject to international arbitrage. For example, land and haircuts aren’t tradeable. In addition, other items are subject to high transport costs and trade restrictions that make these items nontradeable.

- “Consumption baskets” in different countries aren’t the same. Hence, there is no reason for the consumption baskets of different countries to have the same price.

- There might be monopolistic pricing practices in some countries that act to weaken the links between prices of similar goods sold in different countries.

- Governments can follow policies that, at least in the short-run, cause market rates to deviate from PPP. The monetary protectionism policies followed by the US (1985-1987) are but one example.

The PPP phoenix

Recent, high-powered research by Professor Jeffrey Frankel supplies a different view of PPP, however. From the ashes of PPP, a phoenix has risen. Professor Frankel shows that while PPP fails in the short-run, it has merit in the long run because deviations from PPP tend to dissipate over the long run.

Professor Frankel used annual data over the period from 1869 to 1987 to estimate the extent to which the dollar/pound exchange rate returns to PPP equilibrium. For this period, he finds that the estimated speed of adjustment to PPP is 16% per year. Hence, even though PPP doesn’t hold in the short run, it does in the long run.

Implications:

1. PPP should not be used in a short-run trading strategy.
2. Even though government policies might manipulate a currency away from PPP over the short run, these policies cannot be kept in place in the long run.
3. In the long run, currencies tend to march toward their PPP values.
4. The US has stopped its short-run policy of monetary protectionism that caused the dollar to become significantly “undervalued” *vis-à-vis* its PPP. It had to stop this policy because a continuation would have caused undesired inflation. In consequence of this policy change, the dollar has begun its inevitable march toward PPP. In this environment, PPP should be part of a trading strategy. Recall that current PPP rates are 175 yen/\$ and 2.08 DM/\$. Hence our long-run bullish posture on the dollar.

– Dr. Steve H. Hanke

CURRENCIES

On the US\$ and the yen-DM cross

West Germany's strong economic performance, tightening monetary policy (M3 in June showed a rise of 4.4%, seasonally adjusted and on an annual basis over the fourth quarter of last year, compared with 5.3% in May and 6.1% in April over the comparable periods), and excellent current account results, have slowed considerably the US dollar advance. In fact, in the most recent DM rally, the German unit reached further than we had anticipated (touching briefly DM1.85/\$) before retreating to the present DM1.8960 - 1.9100 area.

Our trading short positions in Europe currencies were stopped out, basis a NY close of DM 1.8950/\$. At the same time, however, the yen failed to close below 137, and thus we remained short yen.

This divergent action brought to our attention the deterioration of the yen *vis à vis* the EMS and more particularly the DM.

Charts 2 and 3 depict a long-term decline of the DM *vis à vis* the yen, but indicate that lately the yen's fortunes have begun to wane. One need not look far to explain this phenomenon: a changing political climate in Japan, away from the long-ruling LDP party (*perceived* to have been the architect of Japan's post-war success), very easy monetary policy

(broad money supply in Japan is growing at twice the rate in Germany and more than three times the pace in the US), and a prospective rate of capital outflow exceeding the slowing pace of the current surplus (are Japan's institutions hopelessly addicted to the US capital and real estate markets?).

Clearly, on technical and fundamental fronts, a *cross trade* is suggested: sell yen/buy DM.

STRATEGY: *The recent deterioration of the yen vis à vis the DM indicates that the dollar bulls (including us, of course) should be concentrating all our firepower exclusively on the short side of the yen. (Note: In past issues we already indicated our preference for the short side of the yen rather than the DM or SF). Commercial hedgers with long exposure in the DM, SF, or other EMS currencies should naturally protect themselves by selling anew those currencies forward. Speculators, however, would be best off adding to previously established short yen positions, leaving stops at ¥ 137, New York close.*

More timid speculators, not wishing to take a dollar view, should establish the following cross trade: Buy 4 December '89 DM versus the sale of 3 December '89 yen (to equalize the US dollar equivalents). Place initial stops at 70 ¥/DM.

Chart 2
Yen per Deutsche Mark

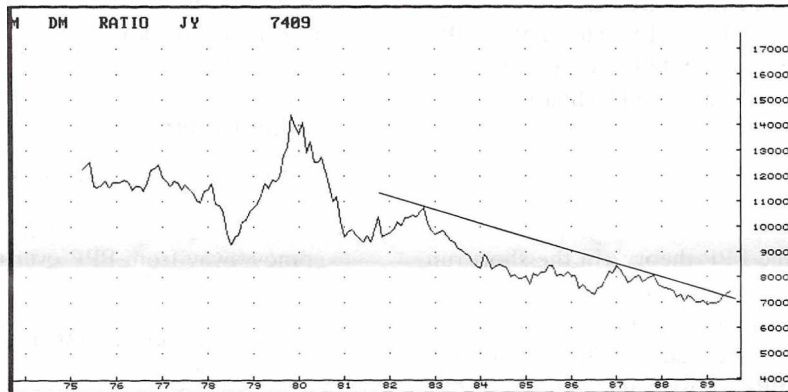


Chart 3
Yen per DM

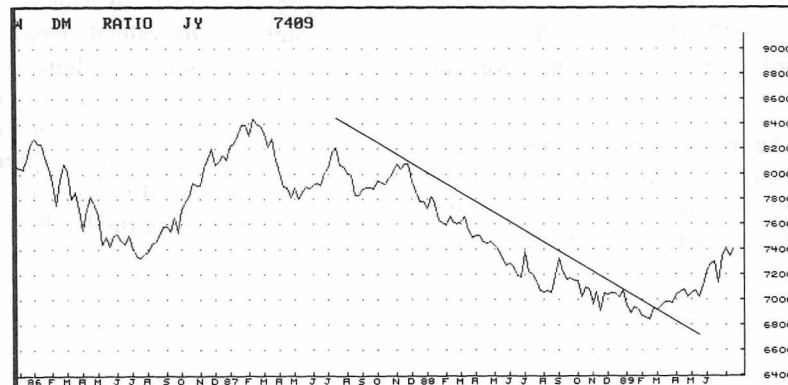




Chart 4
Deutsche Mark (weekly)

Chart 5
Japanese Yen (weekly)

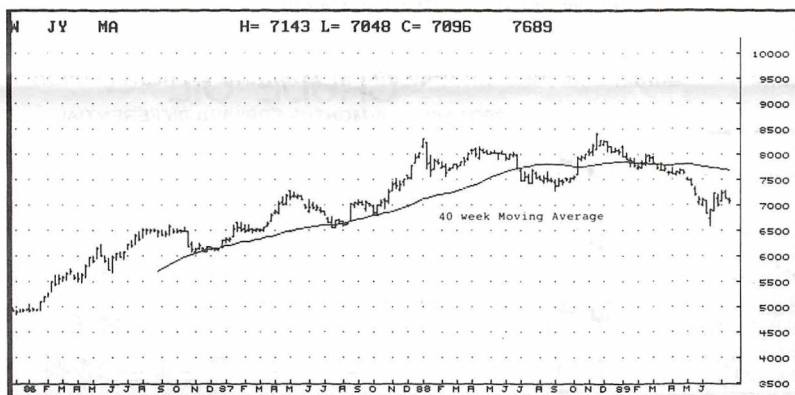
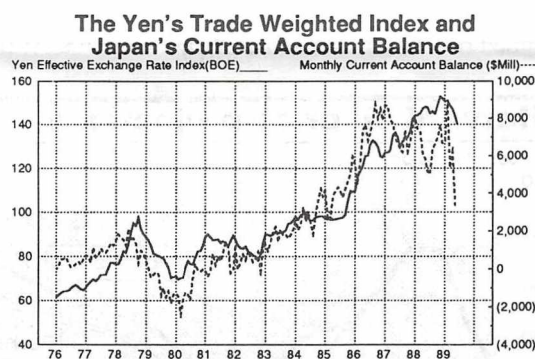


Chart 6



ENERGY FUTURES

Thank you, Harvard University!

Just when we were beginning to worry about no longer finding a true, real bull, an article reached our desk and — would you believe it? — was calling for a \$50 a barrel price by the year 2000.

Professor William Hogan acting director of the Harvard University Energy and Environmental Policy Center in the US concluded that “the soft conditions of recent years present a great opportunity to prepare for likely difficulties that consumers will face in years to come.”

Critics of his earlier projections in 1987 (which forecast a near \$60-a-barrel price by the year 2000 — see Chart 7) point out that he underestimated the extent to which the world would continue to conserve oil even at the current lower prices. In his new projection, Professor Hogan assumes oil demand in line with growth in world output (here he is at variance with the US Department of Energy, even though he generally follows their methods), and he concedes that demand for oil may be less at low prices than earlier anticipated and that energy conservation may continue irrespective of price trends. He takes issue with the conventional view represented by the Department of Energy, which calls for a continued soft market to last through the end of the century, primarily caused by lower growth in oil demand and the

expansion of new Opec supply. As good contrarians, we are grateful indeed to Professor Hogan.

Non-Opec supplies, of course, continue to rise. South Yemen is about to become an exporter of, perhaps, 50,000 to 70,000 barrels per day from a new Bir Ali terminal, thanks to an important Soviet discovery in the Shabwa region. The quantity and good quality of the crude, light and low in sulphur, has triggered a quickening of exploration in the region.

Reserve estimates for the Timor Sea, off Australia, grow apace and now stand above 120 million barrels. Over 100,000 barrels per day (b/d) are already beginning to flow to the surface in this incredibly remote spot. *And at an operating cost of under \$1.00 per barrel.*

But the real pressure for low oil prices comes from Opec members, particularly the Gulf States. Because of heavy buying of oil-loading equipment and increased pipeline capacity to the Red Sea, Iraq may be able to export up to 5.5 million b/d in nine months' time compared with about 3 million b/d at present. And Iran's economic reconstruction will certainly be oil-based, with the objective of reattaining the 6 million b/d output achieved in the days of the Shah.

Those nations, basically in need of money and possessing

known and unknown reserves at least equal to Saudi Arabia's, Kuwait's, and the UAE's, will be vying for output supremacy in the very near future. The outcome *must be* bearish, especially when incentive to cheat (production costs in the region are well below \$2/barrel) are so huge.

Despite apparent price stability, the market's technical underpinnings continue to give way. Our spot/six-month forecast differential, which was so useful in anticipating the November/May rally (see Chart 8), is now signalling an imminent bear move. The narrowing backwardation (from a \$6.60/barrel peak to the present \$1.26) means that supply conditions have become a great deal less tight than they were in the spring of this year. At the same time, refining margins have weakened considerably, auguring poor crude consumption in the months ahead (see Chart 9).

The balance of 1989 promises to be a mirror image of the first half of the year. The recent "false" price stability, will give way to sharply falling prices and a new Opec crisis. Given the extremely "hard" views of some leading Opec members, and present output levels in excess of 21.5 million b/d, it is almost impossible to see a return to 18.5 million b/d let alone 16.5 to 17.0 million b/d, the output level necessary to continue the coming downward price spiral.

STRATEGY: *Falling option implied volatilities provide us an excellent opportunity to add to our bearish posture. Last month we bought deep-in-the-money September 19 puts. Add to the short side by buying December at-the-money puts. Outright short sales of December '89 contracts may be undertaken, with stops at 20.50, close only.*

Chart 7

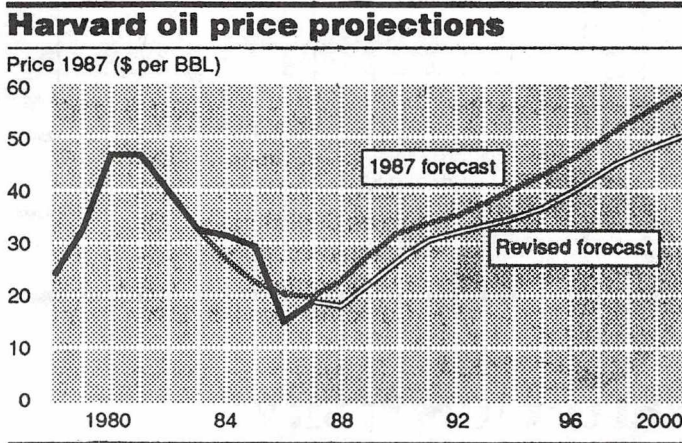


Chart 8

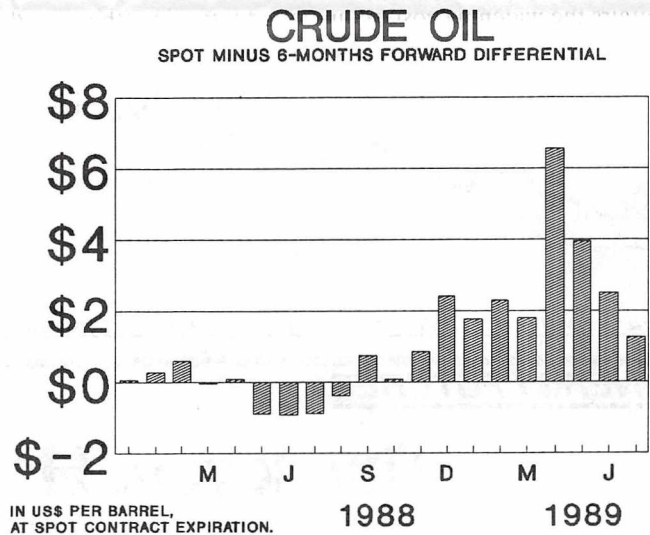


Chart 9

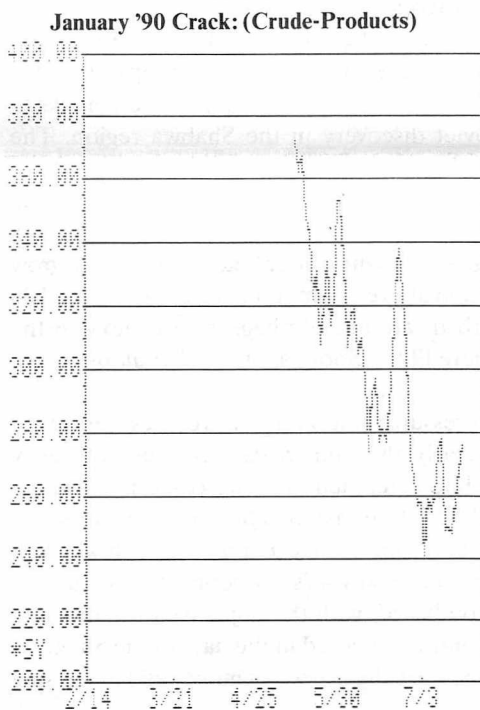
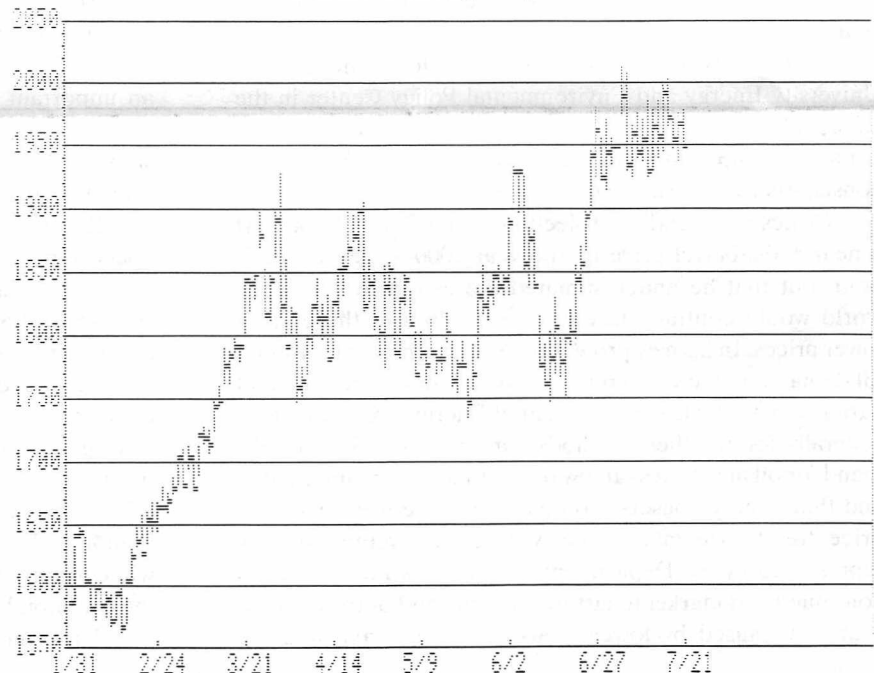


Chart 10
NYME Crude Light Sep '89



STOCK INDEX FUTURES

A blow-off again?

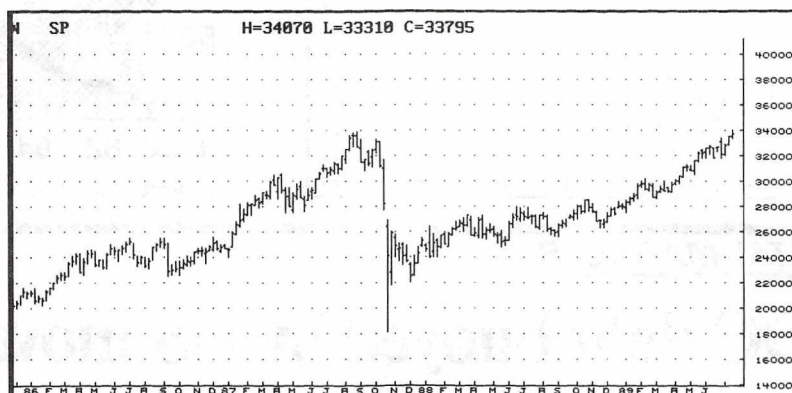
Powered by the delicious prospects of a soft-landing scenario, but principally by an unceasing flow of deals, the big-cap sector of the market continues to roar ahead. The S&P 500 is within a hair's breadth of its all-time high, a development we predicted (but, unfortunately, capitalized on only partially) when the market had retraced two thirds of the August 1987 crash (see *FC&CC* earlier this year).

Recession or no recession, corporate profits are being squeezed, testimony to the twin difficulties of raising prices and dealing with a tight labor market. Add to this state of affairs the widening cost of junk bond financing (the spread has widened to 590 basis points over Treasuries, an all-time

high), itself a result of a number of very serious insolvencies and about-to-be insolvent high-leveraged companies, and you get the strong likelihood of an imminent and dramatic slow-down in takeovers and LBOs. Such a development could take the wind out of the new deals and remove the market's strongest prop.

STRATEGY: *It is a remarkable fact that the long rally that began last November has as yet not produced a correction that has seen the market reach oversold readings (using Trendline's well known oscillator). Are we in the blow-off stage, again? Stay sidelined and stay tuned.*

Chart 11
S&P 500 (weekly)

**PRECIOUS METALS**

Is gold bottoming?

There are a few scattered signs that gold prices are probing for an early bottom. First, it soared relative to silver, bringing the gold/silver ratio to a new recent high of 72.7 (see Chart 12) and in the process stopped us out of the long silver/short gold spread at 69.5 as per our previously suggested stop (May 21).

Second, it has risen in recent weeks almost 6% *vis à vis* the CRB index (see Chart 13), although admittedly the major trend has, as yet, not reversed.

Thirdly the "gold-loan" story is beginning to wear thin and there are indications that their pace is slowing dramatically. As well, production growth in places such as Australia,

where output increases have been fairly dramatic, is showing signs of petering out and even fizzling out (see Chart 14).

It is much too early, we believe, to make a bullish case. The US dollar is strong and inflation is clearly on the wane. Nevertheless, we are becoming *more attentive* to the possibilities of an early bottoming action and have changed our odds to 50/50 from 75/25 on the chances of a move below \$300/oz.

STRATEGY: *Retain long CRB/short gold spread and maintain stop at .58. Remain long October platinum; maintain stop at 478, close only.*

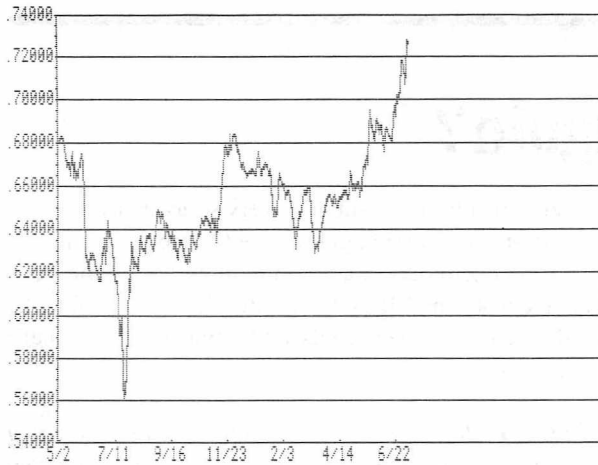


Chart 12
Dec. gold/silver ratio

Chart 13
CRB/Gold Ratio (weekly)

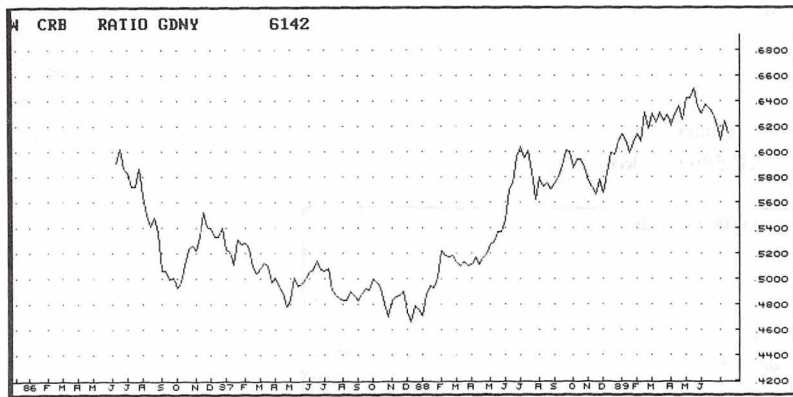
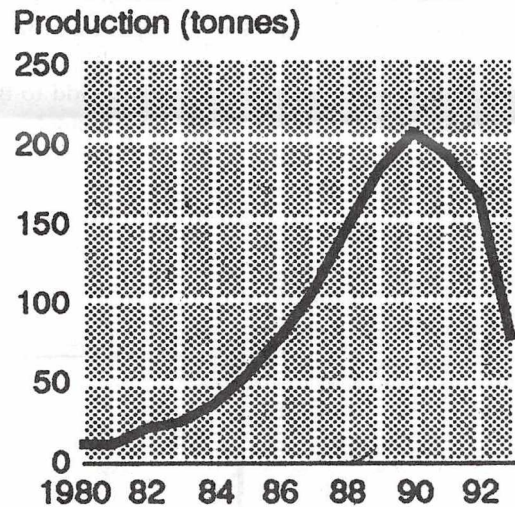


Chart 14
Australian Gold



Source: *Financial Times, London.*

FRIEDBERG CAPITAL MARKETS

LDC debt buoyed by US moves

The latest US debt strategy has done nothing but buoy the LDC debt market since its unveiling on March 10, 1989. It has become clear that as much as US\$30 billion of public funds will be made available to aid the Lesser-Developed Nations repurchase their bank debt, and bolster the value of the remaining outstanding debt. As an example, had an investor purchased Chile's debt in March '89, the capital gain would be 13%, or 40% on a per annum basis, in US dollars; not a bad return for just over four months.

It is widely believed that Mexico and its US bankers have tentatively settled on a plan including options that would give the Mexicans a cut of 35 cents on the dollar in their debt principal, or a 6.25% interest rate on new bonds, which would be exchanged for existing paper. Actually, the whole market for LDC debt would benefit tremendously as the supplies of paper diminish.

Several other factors have been pushing up levels of LDC paper. More LDCs seem eager to allow debt to be deployed in a variety of ways. For instance, it is rumored that Venezuela will commence auctions of Bolivars (local currency) in ex-

change for bank debt. This would hail a new addition to the LDCs currently employing debt-for-equity programs. Another boon has come from Argentina's newly installed president, who has hinted that the new administration will be more willing to consider greater use of debt-for-equity swaps.

Although there is a distinction between the bank debt and external bonds, the new debt plan would indirectly influence the external LDC bonds because the general shrinking of debt will enhance the LDCs ability to service all debt.

We offer the following LDC debt:

Brazil External Bonds 51 bid — 54 ask 27.6% YTM

Due: 15/10/99

Current coupon: 11-5/16

Rate: 6-month LIBOR + 13/16

Amortized 1/14 of principal, semi-annually, starting 1993

Chile (restructured bank debt) 63 bid — 66 ask 16.2% CY

Rate: 12-month LIBOR + 1-1/8

Current coupon: 10-11/16

Chart 15

Date: July 20, 1989
We offer the following Bonds subject to change without prior notice: Minimum amount US\$5,000

PAY ISSUER/MTY./DATE/COUPON	BID	OFFER	CURRENT ANN. YIELD TO MTY.	LAST PAY NEXT DATE
CANADIAN DOLLAR DENOMINATED BONDS				
GOVERNMENT OF CANADA (semi annual) 01/02/90 13 1/4%	100.85 -	101.20	10.84	01/02/89-01/08/89
NEW ZEALAND DOLLAR DENOMINATED BONDS				
TORONTO DOMINION BANK 02/04/90 18% RRSP eligible	100 3/4-	-	-	04/02/89-04/02/90
MCDONALD'S (semi annual) 15/08/90 16 3/4%	102 1/8-	103 1/8	13.89	15/02/89-15/08/89
TOURIST HOTEL (N.Z.) 04/06/93 zero coupon	57 -	59	14.65	matures -04/06/93
AUSTRALIAN DOLLAR DENOMINATED BONDS				
COMMONWEALTH BANK OF AUSTRALIA 01/07/94 14%	97 1/4-	98 1/4	14.50	01/07/88-01/07/89
WORLD BANK 15/03/93 12 3/4% RRSP eligible	96 5/8-	-	-	15/03/89-15/03/90
CAN.IMP. BANK OF COMMERCE 13/03/91 13% RRSP eligible	94 3/4-	95 1/2	15.99	13/03/89-13/03/90
DANISH KRONE DENOMINATED BONDS				
STOCKHOLM 10/11/91 10 5/8%	102 1/8-	102 7/8	9.13	10/11/88-10/11/89
BRITISH POUND DENOMINATED BONDS				
KGDM of SWEDEN 14/4/93 9 3/8%	93 3/4-	94 1/2	11.23	14/04/89-14/04/90
DEUTSCHE MARK DENOMINATED BONDS				
QUEBEC HYDRO 5 1/2% 1/5/96RRSP eligible	92 1/4-	93	6.82	01/05/89-01/05/90
SWISS FRANC DENOMINATED BONDS				
GOVT. OF AUSTRALIA 30/10/98 5%	95 3/4-	96 1/2	5.49	30/10/88-30/10/89
JAPANESE YEN DENOMINATED BONDS				
GOVT. OF CANADA 23/7/93 5 5/8% RRSP eligible	101.05 -	101.80	5.11	23/07/88-23/07/89
U.S. DOLLAR DENOMINATED FIXED CONVERTIBLE BONDS				
PACIFIC SCIENTIFIC 7 3/4% 15/06/03(semi) 67 CV @\$38 p/sh	-	-	-	15/06/89-15/12/89
SUNRISE MEDICAL INC. 7.25% 26/6/96 CV @\$17 5/8 p/sh	67 -	70	14.37	26/06/89-26/06/90
ALLIANT COMPUTER 7.25% 15/05/12(semi) CV@\$39.75 p/sh	48 5/8-	51 1/8	15.29	15/05/89-15/11/89
U.S. DOLLAR DENOMINATED FIXED RATE BONDS				
ALBERTA 7 3/8% 9/12/91 RRSP eligible	97 3/4-	98 1/2	8.06	09/12/88-09/12/89
SOUTHWEST CORP. 10 7/8% 1/11/89 (semi)	-	-	-	01/05/89-01/11/89
U.S. DOLLAR DENOMINATED FLOATING RATE NOTES				
UNITED KINGDOM 24/9/96 3 mo. LIBID-1/8 (qtly)	100.14 -	100.44	9 1/8%	28/06/89-28/09/89
REPUBLIC OF ITALY 30/4/93 3 mo Limean(qtly)	99.45 -	99.85	10.0%	28/04/89-31/07/89
REPUBLIC OF PORTUGAL 8/12/93 6 mo LIBOR +5 B.P.(semi)	99.86 -	100.16	9.3%	08/06/89-08/12/89
BANCO CENTRAL DE BRAZIL 15/10/99 6 mo LIBOR +13/16 (semi)	51 -	54	11 5/16% *** 27.62%	* 17/04/89-15/10/89
BANCO CENTRAL DE CHILE(restructured) 12 mo LIBOR +1 1/8	63 -	66	** 16.19%	20/01/89-20/01/90

** current yield
***yield to maturity

*amortized: 1/14 of principal paid semi-annually starting 1993.

For further information and current prices please call:
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Chart 16

Breakeven exchange rates for US\$ - based investor

This analysis shows a "snapshot" of the relationship between interest rate differentials and rates of exchange. The breakeven rate measures how far the foreign currency has to devalue (for NZ\$, A\$, DKr) or revalue (for DM, SF, JY) before the interest rate advantage/disadvantage is overcome by currency depreciation/appreciation.

	U.S. \$	NEW ZEALAND \$	AUSTRALIAN \$	DEUTSCHEMARK	SWISS FRANC	JAPANESE YEN	DANISH KRONE
1 year	7.88%	McDonald's 16 3/4 15/8/90 yields 13.89% (54.4 NZ/US)					
2 year	7.80%		CIBC 13% 13/3/91 yields 15.99% (.648 A\$/US)				Stockholm 10% 10/11/91. yields 9.13% (6.50 US/Dkr)
4 year	7.80%	Tourist Hotel 0% 4/6/93. yields 14.65% (.449 NZ/US)				Canada 5 1/2% 23/7/93. yields 5.11% (127.92 US/JY)	
5 year	7.80%		CBA 14% 1/7/94 yields 14.50% (.555 A\$/US)				
7 year	7.92%			Hydro Quebec 5 1/2 1/5/96 yields 6.82% (1.77 US/DM)			
9 year	7.97%				Australia 5% 30/10/98 yields 5.49% (1.06 US/SF)		
Spot Exchange Rate	N/A	.574	.7501	1.9055	1.646	141.53	7.371

**For example, in parentheses, since a US\$ based investor would receive 601 basis points (1389-788) by holding the McDonald's 16 3/4% NZ\$ bond, the NZ\$ can depreciate to 54.4 NZ/US from the present spot exchange

rate of .574 NZ/US over the next 1 year for the NZ\$ investment to break even with current US\$ rates of interest. Assumes that bonds are held to maturity, and coupons are reinvested.

Chart 17

Third World Debt Market Rebounds

Average prices of foreign debt, in cents per dollar of face value

	JAN. 5	MARCH 1	JULY 17
Argentina	22	18	19
Brazil	41	28	32
Chile	59	56	65
Mexico	42	34	44
Philippines	48	38	54
Poland	35	32	39
Venezuela	39	27	40
Yugoslavia	45	44	54

Source: Salomon Brothers Inc.

THE EXOTICS

Greece revisited

Last month we concluded that a) Greece was a basket case but that b) based on the best statistical information then available, there was still sufficient time to capitalize on the inevitable devaluation of the drachma. More to the point, international reserves had been uptrending from the 1985 lows of \$1.73 billion to a "recent" \$4.59 billion, and furthermore, government finances are going to show a deficit of "only" 19% of GDP, a "minor" deterioration with respect to the previous years.

More recent statistics belie this temporary Nirvana. A report specially prepared by the Bank of Greece for the interim government, made up of the conservative New Democracy party and a Communist-dominated left wing coalition, indicates that reserves had dropped in the first six

months of the year \$1.08 billion, a dramatic 30% fall, to \$2.09 billion. In addition Mr. George Souflias, the economy minister, in an interview confirmed that the budget deficit was heading for a record 22% of GDP. As bad as we thought the situation was last month, it's worse, much worse, and it's beyond salvation.

STRATEGY: *Given this new and quite revealing information, we advise reentering the short side of the drachma, against both the US dollar and DM. We strongly recommend that you sell forward for a minimum of nine months, although it's quite possible that a maxi devaluation may occur as soon as October or November of this year.*

Australian dollar

Australia's almost intractable current account deficit is equal to approximately 5.2% of GDP and is almost entirely due to the domestic boom. First quarter GDP growth ran at 1.6%, seasonally adjusted, a 5.4% increase over the year-earlier quarter, and exceeding market forecasts of 5%.

The Reserve Bank continues to maintain a high interest rate policy; 90-day bank bills trade at 18% and best credit lending rates border 20%. Credit, on the other hand, remains plentiful with M3 figures showing a year-over-year growth rate of 26.8%, some of it attributed to a shift of funds into bank deposits caused by changes to the Statutory Reserve Deposit arrangements that took effect in September 1988.

Clearly the free flow of credit is masking some serious balance sheet deterioration in the corporate and household sector in typical Ponzi-like fashion. When the music finally stops, i.e., credit aggregates begin to shrink, the disasters will be bared, in much the same way as a receding tide bares the wreckage of a sunken ship. High interest rates are already having some effect, as retail sales for May showed a sharp 4.9% fall, the largest monthly drop since 1965.

It is also quite clear that the deliberate high interest rate

policy is indirectly "financing" the current account deficit. In this environment, a drop in rates would cause a selling panic in the Australian dollar. More likely a steady-as-you-go policy with a tendency to err on the side of higher rates will eventually bring about the inevitable adjustment.

As Australia enters a recession — quite likely a very severe one — the current account deficit will improve rapidly, although perhaps influenced negatively by deteriorating terms of trade. This in turn will allow for a slow drop in interest rates without setting off too sharp a fall in the Aussie dollar.

STRATEGY: *The Australian dollar is caught at present in a timing scenario: It can maintain approximately current levels if Australia enters a recession first and the Reserve Bank reacts in a lagged and cautious manner. Alternatively the Aussie dollar will fall precipitously if the Reserve Bank gives up too soon and acts to lower rates before the recession begins. We tend to believe that the first scenario is more probable and therefore take a neutral view to the Australian dollar at current levels considering that the one-year forward rate is trading at .6900.*

Chart 18

YEAR	A\$ PER U.S. DOLLAR (PERIOD AVG.)	- BASKET -			
		U.S. 1967=1.00	U.S. 1973=1.00	UK 11% Japan 41% New Zealand 9%	US 30% Germany 9%
1967	1.1125	1.0000	1.2931	1.0000	1.3174
1968	1.1125	1.0150	1.3125	0.9029	1.1895
1969	1.1110	1.0418	1.3472	0.9254	1.2191
1970	1.1137	1.0588	1.3692	0.9460	1.2463
1971	1.1361	1.0197	1.3186	0.9376	1.2352
1972	1.1923	0.9494	1.2277	0.9013	1.1874
1973	1.4195	0.7733	1.0000	0.7591	1.0000
1974	1.4378	0.7356	0.9512	0.7230	0.9524
1975	1.3102	0.7662	0.9908	0.7646	1.0073
1976	1.2252	0.7637	0.9875	0.7303	0.9621
1977	1.1090	0.8003	1.0349	0.7833	1.0319
1978	1.1447	0.7730	0.9996	0.7947	1.0469
1979	1.1179	0.8073	1.0439	0.8633	1.1373
1980	1.1395	0.8162	1.0555	0.9038	1.1907
1981	1.1493	0.8122	1.0503	0.8384	1.1045
1982	1.0174	0.8775	1.1347	0.8601	1.1331
1983	0.9024	0.9299	1.2025	0.8685	1.1442
1984	0.8796	0.9524	1.2316	0.8445	1.1125
1985	0.7008	1.1624	1.5032	1.0239	1.3489
1986	0.6709	1.1390	1.4729	1.0784	1.4207
1987	0.7009	1.0397	1.3445	1.0535	1.3879
1988	0.7842	0.8989	1.1624	0.9479	1.2488
1989 (1Q)	0.8475	0.8697	1.1246	0.9056	1.1931

Chart 19

Year	Foreign Assets (Min US\$)	CURRENT ACCOUNT As % of GNP	CUMULATIVE 12 QTR. Current Account (Min US\$)
1970	1,817	-2.35	-3135
1971	3,330	-2.11	-2621
1972	6,079	+0.09	1250
1973	5,776	+0.06	+ 11
1974	4,137	-3.44	-1952
1975	3,653	-1.13	-3408
1976	2,571	-1.99	-5780
1977	2,952	-3.00	-6040
1978	3,411	-4.06	-9563
1979	4,016	-2.16	-10267
1980	6,573	-2.90	-11331
1981	4,474	-5.10	-15302
1982	8,912	-5.22	-21169
1983	11,487	-3.80	-22972
1984	9,573	-4.92	-23034
1985	7,012	-5.68	-23231
1986	4,953	-6.08	-26990
1987	5,928	-4.69	-27213
1988	9,476	-4.63	-29442

Chart 21

Rates	Spot	1 Month	3 Month	6 Month	12 Month
	.7475 -	.7425 -	.7310 -	.7160 -	.6900 -
	.7485	.7440	.7325	.7175	.6920

Chart 20

HARD CURRENCY COVER (In millions of U.S. Dollars)

Reserves * + Previous 12-months curren Account *** = 2,100
 (Reserves + 12-months C/A) / M1 ** = 6.8%
 (Reserves + 12-months C/A) / Broad Money ** = 1.5%

*As at June 1989 ** Jan. 1989 *** 1988 III - 1989 II

Figures in millions of U.S. Dollars

	M1 (Converted to U.S. Dollars)	Broad Money (Converted to U.S. Dollars)
1979	16,207	52,600
1989-Jan 30,812		132,458

% Increase 90.1% (decrease) 151.8%

Corresponding % increase in the United States 99.7% 102%

(a) 1988 Imports as percentage of GNP =14.32
 (b) 1979 - 1988 Imports as percentage of GNP = 14.15
 1988 /1977 - 1988 average) = (a)/(b) = 99.78%

Source: IFS

FOREX RATES & UPDATE

<i>Currency</i>	<i>Spot</i>	<i>3-Month</i>	<i>12-Month</i>	<i>Comments vis à vis US\$</i>	<i>Comments vis à vis DM (Spot DM: 1.9060)</i>
Belgian franc	39.70-39.80	39.63-39.76	39.53-39.73	Sell**	Neutral
Danish krone	7.3800-7.3850	7.3865-7.3910	7.4355-7.4545	Sell**	Neutral
Dutch guilder	2.1395-2.1405	2.1300-2.1315	2.1105-2.1130	Sell**	Neutral
*Greek drachma	163.90-164.10	167.70-171.90	179.70-190.40	Sell	Sell
Hong Kong dollar	7.8065-7.8075	7.8035-7.8075	7.8015-7.8225	Neutral	Buy**
Irish punt	1.4100-1.4115	1.4080-1.4100	1.3880-1.3930	Sell**	Neutral
Italian lira	1370-1371	1381-1383	1415-1420	Sell**	Neutral
Kuwaiti dinar	.29600-.29660	.29540-.29650	.29430-.29660	Sell**	Neutral
Malaysian ringgit	2.6790-2.6800	2.6680-2.6710	2.6300-2.6400	Neutral	Neutral
New Zealand dollar	.5745-.5755	.5678-.5708	.5470-.5520	Neutral	Neutral
Norwegian krone	6.9500-6.9550	6.9840-6.9920	7.1030-7.1185	Sell**	Neutral
Portugese escudo	159.30-159.80	161.80-162.70	165.20-170.80	Sell**	Neutral
Saudi Arabian riyal	3.7500-3.7510	3.7485-3.7500	3.7480-3.7520	Remain short	Remain short
Singapore dollar	1.9560-1.9570	1.9410-1.9440	1.9010-1.9120	Neutral	Neutral
Spanish peseta	119.60-119.80	121.30-121.60	126.10-126.80	Sell**	Neutral
Swedish krona	6.4775-6.4825	6.5210-6.5285	6.6510-6.6610	Sell**	Neutral

Explanatory Notes

*Indicates change in recommendation from last issue.
 **Stopped out on the basis of 1.8950 DM, New York close. Reinstate short positions as per currency comments in this issue.
 Currency expected to firm against both currencies.
 Currency expected to strengthen against US\$ and weaken against DM.
 Currency expected to weaken against both major currencies.
 Currency expected to weaken against US\$, but strengthen against DM.
 Term used to liquidate short position but does not imply a new buy recommendation.
 Term used to indicate sale advice of previous long position, but does not imply a new short sale recommendation.

Buy
 Buy
 Sell
 Sell
 Cover
 Liquidate

HOTLINE UPDATE

Tuesday, June 20: Market letter will be mailed tomorrow.	Due to the holiday, the next regular update will be Friday, July 7.
Friday, June 23: Raise stops on long October sugar positions to 1260, close only.	Friday, July 7: No changes or new recommendations.
Tuesday, June 27: No changes or new recommendations.	Tuesday, July 11: No changes or new recommendations.
Friday, June 30: No changes or new recommendations.	Flash update, Friday, July 14, 9:35 a.m.: Reinstate long October sugar positions at market. Place initial stops at 1235, good anytime.
Monday, July 3: No changes or new recommendations.	Tuesday, July 18: No changes or new recommendations.

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