

# FRIEDBERG'S

## COMMODITY & CURRENCY COMMENTS

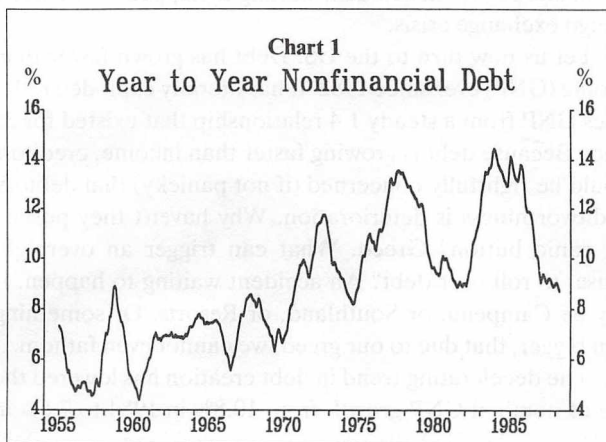
Friedberg Commodity Management Inc.



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## Debt growth falters: is liquidation next?

Take a close look at Chart 1. What is remarkable is not the fact that year-on-year growth of debt has slowed so dramatically (ever since it peaked at 14.4% in 1984), but that the postwar uptrend has been broken. Note how every important "low" was higher than the previous one, while every important "high" was also higher than the previous peak. Are we on to something significant? Are we measuring this "significant event" correctly? What does it mean? What does it portend?



Investment Strategy, Merrill Lynch

There never was (at least to the writer's knowledge) a treatise that formally incorporated the expansion/contraction of debt and its impact on economic activity. The answers therefore are highly conjectural, but because they could be foreshadowing a once-in-a-generation economic event, we'll attempt to make a go.

First, a few logical premises. The extension of debt produces, at least in the short run, an acceleration of economic activity. Households borrow ahead of time in anticipation of a stream of future earnings: without debt, they would have to wait until savings accumulated sufficiently to purchase the larger-ticket items. Businesses too could make substantial investments without having to wait for retained earnings to accumulate. These "facts" seem undisputable.

It follows that, economywide, a certain level of expenditures is achieved, thanks in part to debt. Moreover, house-

holds and businesses (henceforth consumers) must borrow, in the following year, a little bit more money to simply sustain the previous year's expenditure level. Table I shows an example, assuming a 5% gain in income (for simplicity's sake, we are ignoring savings, the fluctuations in savings, and the role of government).

Table I	1988	1989	1990
Consumer income	\$100	\$105	\$110.25
Increase in debt	10	10	10.00
	\$110	\$115	\$120.25

In a world with zero interest rates, the above analysis will lead to the conclusion that a steady, non-accelerating increase in debt will produce rising expenditures, or GNP, provided the rising debt load can be rolled over continuously. This last provision is crucial.

If debt continues to grow at \$10 per year and income increases at 5% per year, then overall debt will grow in relation to income *until* the gains in income begin to exceed \$10 per year, at which point consumers can begin amortizing their debt. Changing the assumption, if debt were to grow at 6% of income, while gains in income continue at 5%, then the debt/income ratio will grow exponentially. Creditors would be correct in assuming that consumers' creditworthiness was deteriorating. Consequently, they might not roll over maturing debt.

### In this issue

Time for an economic downshift? The strengthening dollar. The stock market: living on borrowed time. The big story in oil: booming production. Also, precious metals, copper, sugar, and Friedberg Capital Markets. Contributions by Albert D. Friedberg, Dr. Steve H. Hanke, Daniel A. Gordon, Michael D. Hart, and Lorenzo DiIorio.

But, we know from our original premise that debt must grow at least as fast as the previous year to maintain the rising curve of expenditures (or GNP). If the rate of growth of debt falters, then, expenditures will have to fall. A look at Table II will convince us that decelerating debt growth will cause expenditures/GNP to rise less than income (1988) and may even cause a net fall in expenditures (1990).

Table II	1988	1989	1990
Consumer Income	\$100	\$105	\$110.25
Increase in debt	10	6	0.50
Total expenditure	\$110	\$111	\$110.75

Will the introduction of interest rates into our discussion make a difference? The answer is rather complex. It would appear that a 10% coupon on debt will necessitate an increase in debt extension of approximately \$11 in the second year to sustain a smooth 5% increase in expenditures (see Table III).

This is because consumers need to dip into income to service the interest bill, and therefore expenditures will be impacted negatively if debt extension is not increased. In effect, consumers need to increase their borrowing by their cost of servicing the debt.

Table III	1988	1989	1990
Consumer income	\$100	\$105	\$110.25
Minus interest bill (at 10%)	0	1	2
Increase in debt	100	104	108.25
Total expenditure	\$110	\$115	\$120.25

The true impact is not that simple. After all, the new class of consumers, called creditors, now show an income of \$1 in 1989 and \$2 in 1990. If they spent their income too, then consumers as a whole will not need to increase borrowing from \$10 to \$11 in 1989 and to \$12 in 1990 but can continue to increase their debt load by a steady, non-accumulating amount of \$10 per year to achieve 5% yearly gains in income. Income has shifted from the debtor class of consumers to the creditor class. Of course, one can complicate matters by assuming that the debtor class has a higher propensity to consume than the creditor class, etc. For simplicity's sake, we will treat all classes as equal "spenders." We can, thus, ignore interest costs in our debt analysis.

The crucial variable, as we have seen, is the rate of growth of income. Should it fall behind the rate of growth of debt, then debt takes on an exponential curve — sending jitters through the creditor community and potentially impeding the all-too-necessary process of debt rollover.

*This is exactly what happened in Latin America in 1982-89 with the added complication that debt service was withdrawing purchasing power from the local economies because creditors were — unlike our example of a domestic creditor class of consumers — non-residents.* This phenomenon has been called, from the perspective of Latin America, the negative transfer of resources.

Fortunately, for Latin America, rollover of debt did take place — under forced conditions, elegantly called "reschedulings." There was little the creditors could do, for they had no access to debtor assets. While creditors did extend a modicum of new debt, the "fresh money" as it was euphemistically called was barely sufficient to cover the debtor's interest payment. In effect, debt extension decelerated to zero and may have even turn into partial debt liquidation.

The impact on Latin American economies was, as we have postulated, nothing short of devastating, with real GNP falls of as much as 40% over the entire period.

Why did creditors refuse to roll over Latin debt? Because debt had begun to grow exponentially, as it began to exceed — sometime in 1980 with the collapse of international commodity prices — the rate of growth of income. Why did they wait three years before pushing the panic button? Greed. What caused credit to come to a screeching halt in late 1982? An accident waiting to happen — Mexico's foreign exchange crisis.

Let us now turn to the US. Debt has grown faster than income (GNP) ever since 1982. It has literally exploded to 1.9 times GNP from a steady 1.4 relationship that existed for 35 years. Because debt is growing faster than income, creditors should be rightfully concerned (if not panicky) that debtors' creditworthiness is deterioration. Why haven't they pushed the panic button? Greed. What can trigger an overnight refusal to roll over debt? An accident waiting to happen. It may be Campeau, or Southland, or Resorts. Or something even bigger, that due to our greed, we cannot even fathom.

The decelerating trend in debt creation has lowered the rate of nominal GNP growth from 10.8% in 1984 to 7.5% in the II Q 1988 to II Q 1989 period. One could argue that debt and GNP are mutually interdependent and that the slowdown of GNP (and inflation) caused the slowdown of debt. It may be true for the period leading to the end of 1987. Since, then, however, other factors have begun to independently affect debt growth. Specifically, a) the dramatic slowdown in the rate of growth of money supply (still continuing); b) the clampdown on S&Ls and the coming increase in banking capital ratios (see "Credit implosion?" *FC&CC* Oct. 1988); and c) the very poor state of household and corporate balance sheets, which is already scaring away some lenders. There is, at this time, no indication that any or all of these factors should reverse.

The trend in debt creation is down. *Can it lead to outright debt liquidation?* Remember, in Latin America, debt extension suddenly decelerated to zero, but forced reschedulings avoided the trauma of massive debt defaults.

Unlike the Latin American case, creditors in the US are

in a position to call loans and/or foreclose on assets. Should an "accident" occur, debt liquidation may be a distinct possibility. The result may be a depression of the order of the one experienced in the '30s.

Although debt growth has been decelerating for five years, it is *still* growing exponentially in relation to income. As a result, creditworthiness is falling. This is a FIRST in more than 50 years. It should therefore not surprise anyone that creditors will, at some point, panic and trigger debt liquidation.

Debt liquidation means, as we have seen, falling GNP. But it also means asset liquidation through foreclosures; sales of securities, real estate, and other hard assets. Remember the debtors are at the reach of the creditors (not like in Latin America). All our forecasting abilities regarding future GNP growth (see the following article) may come to nought in the juggernaut of debt liquidation.

Of course, the reader will point to the great savior, Uncle Sam. And, of course, ultimately it is Uncle Sam that could save the day: deficit spending through debt creation to offset debt contraction in the private sector. The spending required, however, to turn the ship around is staggering; It must offset the liquidation of debt and then some. We are talking of magnitudes of 10% to 30% of GNP versus present federal spending of 20% to 22% of GNP and a federal deficit of 2% of GNP. Can Congress act that quickly and in such a timely fashion? We doubt it; it may take two to three years before the gravity of the problem is fully appreciated and the cure is understood.

The Fed, of course, will attempt to reflate and pump the monetary aggregates. But lenders may not care much about the interest rate if they are interested in reducing exposure. Moreover, the rate of defaults could widen interest rate spreads so much between private credits and risk-free Treasury bills, that easy money and falling rates will have little or no impact on creditors' assessments. Junk bond followers know this to be true *today* (see Chart 2) while we are still in the midst of debt extension. The Fed may end up pushing on a string, impotent in its efforts to reverse the course of debt deflation. And with its present concern with inflation (a bill is moving through Congress sponsored by Rep. Stephen Neal, Chairman of the House Banking Sub-Committee, that will instruct the Fed to drive for a zero inflation rate within five

years), it is likely to react at a snail's pace.

The possibility that the US (and Japan, UK, and Australia) will enter a phase of debt liquidation is becoming more real with each passing day. Conventional economic forecasting will not be of much use as it fails to take into account (1) financial accidents and (2) creditors' state of mind. Chart 1 is ominous because it depicts a relentless downtrend that shows nary a sign of reversing despite continued economic growth. It depicts a creditors' fatigue of sorts. Will the fatigue turn into panic?

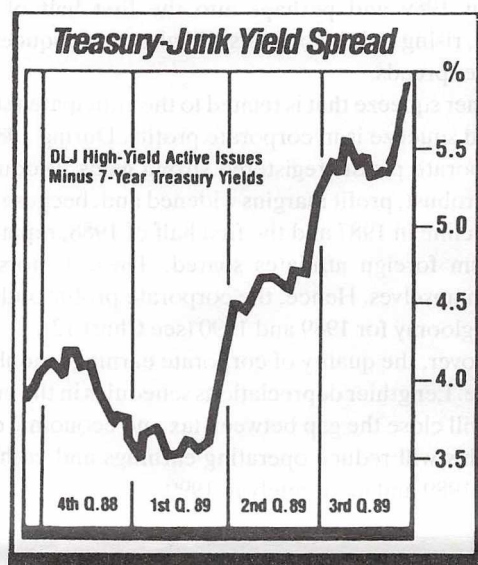
**STRATEGY:** *In the impossible-to-pinpoint debt liquidation scenario, all bets are off.*

*Most probably, Treasury bills and Treasury bonds are desirable. Buy calls. Almost certainly, stock prices and low-quality securities are headed substantially lower. Buy puts.*

*As well, commodity prices head lower. Since we trade these continuously, we will ignore the Big Picture and use protective stops judiciously.*

*The comments that follow do not take into account the above scenario. Life must go on. But forewarned is forearmed.*

Chart 2



Barron's/Donaldson, Lufkin & Jenrette

**THE ECONOMY**

**Time for an economic downshift**

For the past year, we have been cautiously optimistic about the economy. To date, we have been on target. Indeed, most of the economic news has been a bit better than the economic pundits had predicted or market participants had anticipated. For example, since our last issue (July 23, 1989), the markets have been dealt one little positive news shock after another. In consequence, economists and market participants are generally much more optimistic about the economy than they were in July.

Our position remains unchanged. We are still *cautiously* optimistic. However, our views must be put into context. Since our positions remains unchanged and most economists and market participants have become more optimistic about the economy, we have become relatively more pessimistic. Moreover, recall that in July, we used yield curve equations to forecast economic growth of 1.6% to 1.7% for the 1989:3 to 1990:3 period. At present, these indicators still point to 1.5% to 1.75% growth over that period. Although these growth

rates do not signal a recession, they do suggest a downshifting from the 3.7% and 2.7% growth rates that were registered in 1989:1 and 1989:2. In consequence, we anticipate that economic news shocks will shift from positive to negative.

To support our position, let us first look at the monetary side of the economy. The yield curve remains virtually flat (see earlier comments on yield curve equations). The money supply numbers also confirm the Fed's constrictiveness (see Chart 3). These data suggest an economic downshift.

### Supply-side spreads squeezed

Next look at the real side of the economy. Chart 4 displays our supply-side spreads. After all the revisions in the government's economic data, the spreads are healthy. Indeed, they signal continued economic growth. However, we have some reservations about the supply-side spreads. With a downshifting of economic growth, prices will tend to moderate. This will act to squeeze the spreads. More importantly, unit labor costs continue to rise well after nominal GNP growth has peaked. Indeed, unit labor costs continue to increase from four to six quarters after nominal GNP has peaked. This means that unit labor costs will continue to rise throughout 1989 and perhaps into the first half of 1990. Therefore, rising unit labor costs will also act to squeeze the supply-side spreads.

Another squeeze that is related to the anticipated supply-side spread squeeze is in corporate profits. During 1987 and 1988, corporate profits registered strong gains. Product demand was robust, profit margins widened and, because of the dollar's decline in 1987 and the first half of 1988, repatriated profits from foreign affiliates soared. These factors have reversed themselves. Hence, the corporate profits outlook is decidedly gloomy for 1989 and 1990 (see Chart 12).

Moreover, the quality of corporate earnings should also deteriorate. Lengthier depreciations schedules in the current tax code will close the gap between tax and economic depreciation. This will reduce operating earnings and cash flows sharply in 1989 and moderately in 1990.

### Implications

The implications of our views about the course of the economy suggest that the Fed will be forced to loosen its grip on monetary policy in the coming months. Hence, interest rates will fall. The Fed's monetary policy typically reflects current economic performance and inflation trends. Chart 5 shows the Fed's projections for economic activity and inflation. These are presented each February during the Chairman's Humphrey-Hawkins testimony. Whenever the economy and inflation perform outside the Fed's forecasts the Fed changes monetary policy. This can be seen by examining the changes in the federal funds rate (December to December). When the economy is "too slow," the federal funds are reduced, and vice versa.

Looking ahead to the end of the year, we anticipate that inflation will fall within the Fed's forecast. However, with the coming economic downshifting, the second half of 1989 will generate GNP growth rates at the low end of the Fed's forecast or below. In consequence, we anticipate that the December 1989 federal funds rate will be below the 8.75% level registered in December of 1988.

— Dr. Steve H. Hanke

Chart 3  
MONETARY BASE GROWTH RATE  
LOG REGRESSION TECHNIQUE

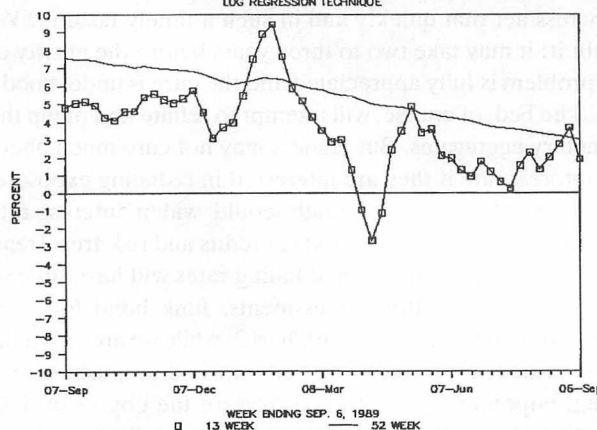


Chart 4 – Supply-Side Spreads (Rates of Change)

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	1.7	6.6
89 1	0.8%	7.3%
2	2.2%	7.4%

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 5  
Federal Reserve Projections, Actual Economic Performance, and Interest Rate Trends

	Percentage Change, Fourth Quarter to Fourth Quarter:						Federal Funds Rate	
	Real GNP Fed <sup>a</sup> Projection	Nominal GNP Fed Projection	GNP Deflator Fed Projection	Actual	Actual	Actual	Levels Dec-Dec	Percentage Point Change
1982	1/2-3	-1.9	8-10 1/2	3.1	6 1/2-7 3/4	5.1	12.4-9.0	-3.4
1983	3 1/2-4 1/2	6.5	8-9	10.4	4-5	3.6	9.0-9.5	+5
1984	4-4 3/4	5.1	9-10	8.6	4 1/2-5	3.4	9.5-8.4	-1.1
Memo:								
1984, 1st half <sup>b</sup>		8.1		12.1		3.6	9.5-11.1	+1.6
1984, 2nd half <sup>c</sup>		2.1		5.3		3.2	11.1-8.4	-2.7
1985	3 1/2-4	3.6	7 1/2-8	6.6	3 1/2-4	2.9	8.4-8.3	-1
1986	3-3 1/2	2.0	6 1/2-7	4.5	3-4	2.8	8.3-6.25	-2.05
1987	2 1/2-3	5.0	6 1/2-7 1/4	8.3	3-3 1/2	3.1	6.25-6.75	+5
1988	2-2 1/2	2.7	5 1/4-6	7.0	3 1/4-3 3/4	4.1	6.75-8.75	+2.0
1989	2 1/2-3		6 1/2-7		4 1/2-5		8.75-	

NOTES:  
<sup>a</sup> Federal Reserve projection is central tendency of projections of FOMC members and Federal Reserve Presidents, published each February in the Federal Reserve Board's annual *Monetary Policy Report to Congress* and accompanying Humphrey-Hawkins testimony  
<sup>b</sup> Actual GNP and inflation are annualized growth rates from 1983:IV to 1984:II; interest rates are from December 1983 to June 1984.  
<sup>c</sup> Actual GNP and inflation are annualized growth rates from 1984:II to 1984:IV; interest rates are from June 1984 to December 1984.

**CURRENCIES**

# The strengthening dollar

The US dollar continues to strengthen, fuelled primarily by economic data, low money growth, and continuously improving balance of trade performance.

Of some concern is the recent rise of bullish sentiment; being a confirmed bull market, however, one can hardly quarrel with the fact that dollar bulls outnumber bears 4-1. It does make for a more volatile environment — as Friday's trading proved, where the dollar/yen swung from an opening of 147.15 to a high of 149.00 and a low of 144.00 before closing at 146.35, buffeted by a myriad of economic statistics and rumors of all sorts.

By its own admission, the Fed spent \$12 billion in the May-July period, while other central banks are thought to have spent another \$35 to \$40 billion in the attempt to stop the dollar from shooting up, an annualized \$200 billion. Putting the matter in perspective, it means that private capital inflows to the US are handily exceeding current account outflows, a fact that is borne by the casual observation that the US dollar has risen. Capital flows, not trade flows, are what drive currency volume, as we have too many times stated in earlier issues. Someone should tell that to Fred Bergsten, Director of the Institute for International Economics and his colleague William Cline who from their ivory tower warn that the US current account deficit will widen to \$200 billion by 1992. Using bombastic language, they declare that the "G-7 process is now in shambles" and that the "Treasury, the Fed, etc. know that what's happening now is simply storing up trouble for the future..." and finally "the chickens will come home to roost in about six months."

Do we really care if the current account deficit widens to \$200 billion in 1992? Doesn't that mean that the capital account widens to a surplus of \$200 billion too? Besides, a \$200 billion C/A deficit in 1992 will probably be smaller in relation to GNP than the present C/A deficit; relative numbers are significant, gentlemen, not absolute numbers (as we

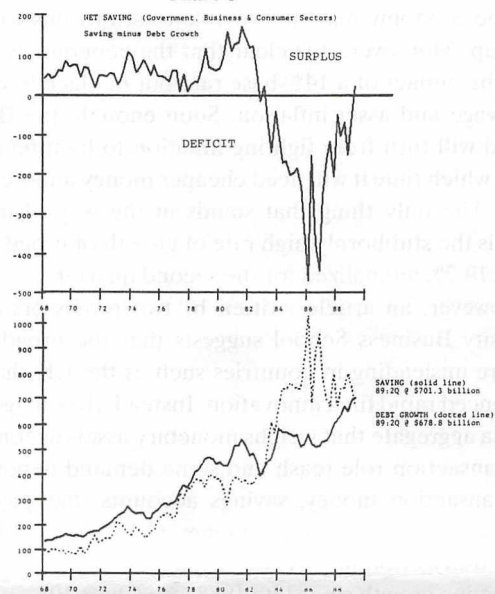
stated in one of our first bullish analyses of the US dollar back in August 1988.

Finally, do those gentlemen doubt that net savings in the US have been rising rather dramatically over the past three years, pointing to a possible current account surplus in the not too distant future (see Chart 6)? Thank goodness for their profound lack of understanding, or else who would take the other side of our trade?

**STRATEGY:** Remain long US\$/short yen. Place stops at 141.90, close only, basis NY close.

Remain long DM/short yen spread; raise stops to 71.90, basis December '89 IMM contracts.

Chart 6



Source: C.J. Lawrence

Chart 7  
CME Japanese Yen Sep '89

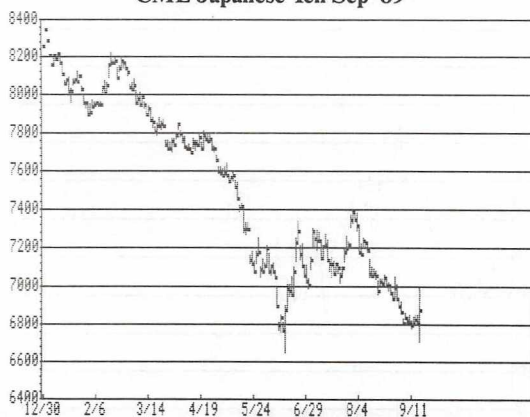
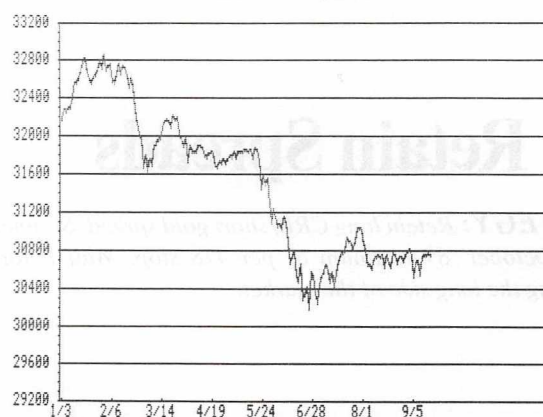


Chart 9 - BP/DM



**CURRENCIES**

# Shorting the cross, once again

There is every indication that the UK has entered a recession. And it promises to be a nasty one.

Retail sales, in volume terms, are flat with last year's third quarter, industrial production is below last year's second quarter, and real GDP is down one quarter, thus far. Bank lending continues at a high pace, but it may be influenced by M & A activity; more significantly consumer credit, at £251 million in July is down precipitously from May's £505 million. As unreliable as British statistics are, the trend is unmistakable: the UK is in an economic contraction.

The external sector is a huge drag as the visible trade balance records deficits of £5.8 to £6.2 billion on a quarterly basis (4.6% of GNP on an annualized basis). While generous income from its substantial foreign portfolio and massive international reserves can cushion Sterling for quite some time, the economy may not be able to afford this widening trade gap. Moreover, it is clear that the economy is wilting under the impact of a 14% base rate put in place to combat rising wage and asset inflation. Soon enough, the Bank of England will turn from fighting inflation to fighting depression, at which time it will need cheaper money and a cheaper pound. The only thing that stands in the way of cheaper money is the stubbornly high rate of growth of broad money (M4) at 19.2% annualized for the second quarter.

However, an article written by two professors at City University Business School suggests that the broad aggregates are misleading in countries such as the UK that have experienced rapid financial innovation. Instead, they suggest that a Divisia aggregate that weighs monetary assets according to their transaction role (cash and some demand deposits are pure transaction money, savings accounts that pay some interest are partly transaction money, CDs that pay full rates are not transaction money) has been showing clear signs of decelerating growth since late 1988 (see Chart 10).

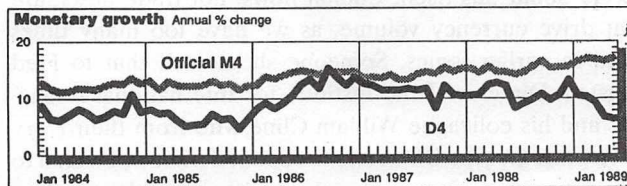
If they are right, Divisia clears the way for the Bank of

England to lower the Base Rate in steps, starting immediately. Should the Bank instead wait for confirmation from Mo (which is still growing above the upper target of 5%, although receding towards it), we may have to wait another 60 days before it signals a rate reduction. In that case, the damage to the economy from overstay could be significant.

Either way, Sterling is likely to see a reduction in interest rates accompanied by a lagging and powerful wage inflation, a bear's delight. Simultaneously, the Bank will be willing to allow Sterling to drop (in a managed way) to improve international competitiveness and cushion the domestic recession.

**STRATEGY:** Sell March '90 British pound/buy March '89 DM, making certain you equate the dollar equivalent. The implied cross, basis March '90, is 2.99 DM/£ versus a spot 3.07 DM/£. We estimate that the entire risk lies in the forward discount.

Chart 10 - U.K. MONETARY GROWTH  
Annual % Change

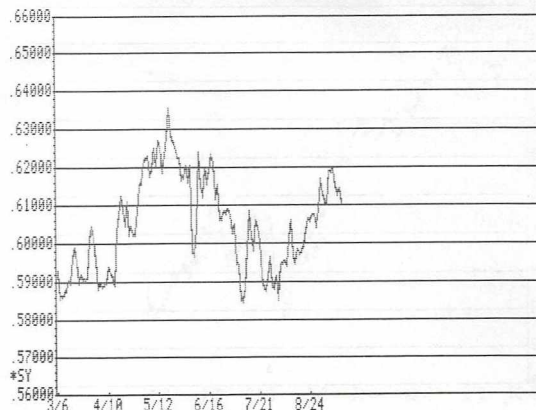


## Canadian dollar

The prospective current account deficit will shortly spook the most ardent bull. At the same time, the Bank of Canada may have difficulty in widening much more the short-term US-Canada interest rate differential in view of weakening economic data. The Canadian dollar should fall.

**STRATEGY:** Continue buying long-term puts.

Chart 11 - CRB/Gold



**PRECIOUS METALS**

## Retain Spreads

**STRATEGY:** Retain long CRB/short gold spread. Stopped out of October '89 platinum as per 478 stop. Wait before reentering the long side of the market.

**STOCK INDEX FUTURES**

# Living on borrowed time

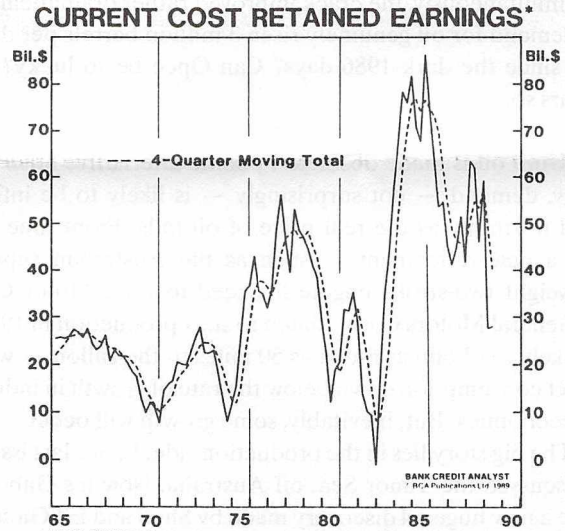
The twin pincer of falling corporate profits (squeezed by rising unit labor costs and the difficulty of raising prices) as Chart 12 depicts quite vividly, and widening high-quality/low-quality yield spreads (see Chart 2) is certain to put an end to LBO activity, the stock market's main prop in recent years. For those who doubt this, please refer to a chart of the Dow Jones Transportation Index: a classic spike stop, caused by the notion that LBO frenzy was about to spread from UAL to all US airlines.

In the meantime, the list of stocks making new 12-month highs grows shorter, despite the flirtation with new highs in the Averages, eerily reminiscent of September 1987. To top it off, bullish sentiment continues to wax with the latest *Investors Intelligence* reading at 52.5%, twice the 26.7% claiming to be bears.

The bull market is now living on borrowed time. Earnings are likely to continue shrinking (see forecast of unit labor costs in Dr. Hanke's article) and falling interest rates are a Treasury affair and have little to do with corporate money costs. And, of course, somewhere, sometime, a recession is looming if debt deceleration turns into debt deflation (see first article).

**STRATEGY:** Buy slightly out-of-the-money December '89 and March '90 puts.

Chart 12



\*NON-FINANCIAL CORPORATE SECTOR RETAINED EARNINGS WITH IVA, CCA AND GEARING ADJUSTMENT AT ANNUAL RATES.

Bank Credit Analyst

**COTTON**

# Cotton supplies tightening

The global cotton supply/demand situation continues to tighten. Ending stocks are estimated to be 25 million bales, one million below last month's forecast and the smallest since 1983-84. Stocks may fall below 30% of annual consumption, the lowest since World War II. World consumption is up 2% over last year whereas production is down 4%.

The US crop is projected at 12.3 million bales, more than three million below last year.

Foreign cotton stocks could fall to 21.3 million bales, a million below last month and nearly two million bales below beginning levels. Stocks are expected to remain extremely tight in large producing countries such as China, USSR, Pakistan, and India, which account for about two thirds of foreign output.

**STRATEGY:** Due to low implied volatility (16%), buy March at-the-money cotton call options.

Chart 14

World Supply and Demand Report for Cotton

Washington-Sept. 12 - FWN — Listed in millions of 480 lb. bales.

**WORLD COTTON**

	1989/90 9/12	1989/90 8/10	1988/89 9/12	1988/89 8/10
Supply				
Beg. Stocks	30.14	31.06	30.78	30.82
Production	80.78	80.62	84.00	84.01
Imports	24.96	24.92	25.48	25.17
Disappearance				
Mill Use	85.34	85.07	83.80	83.43
Exports	24.95	24.99	25.63	25.22
# Loss	0.39	0.34	0.69	N/A
Ending Stocks	25.20	26.19	30.14	31.06

# Reflects cotton lost or destroyed in the marketing channel.

**ENERGY FUTURES****Production boom!**

A not-so funny thing happened on the way to lower oil prices.

It is not that oil prices are not going lower. They are. But not just yet. The spread between spot and the six-month forward position has rebounded from a 10¢/barrel low to a recent \$1.20/barrel, denoting once again a tighter spot market. Simultaneously, the crack improved rather dramatically. Has demand for oil genuinely risen 3 million barrels per day (b/d) since the dark 1986 days? Can Opec be so lucky? It appears so.

But the *real* bear argument does not rest on the demand side. Until oil is made obsolete by some alternative form of energy, demand — not surprisingly — is likely to be influenced favorably as the real price of oil falls. From time to time, a new refinement — such as the Australian super-lightweight two-stroke engine licenced to Ford Motor Co. and General Motors Corp., slated to start production in 1992 and likely to obtain as much as 50 miles to the gallon — will ratchet consumption down below the rate of growth in industrial economies. But, inevitably, some growth will occur.

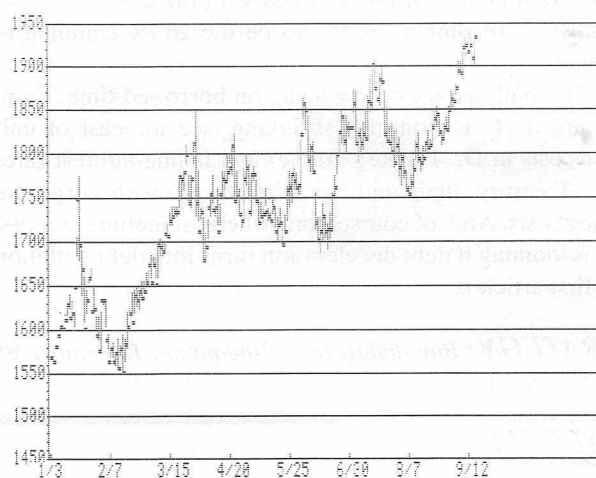
The big story lies in the production side. In our last issue we discussed the Timor Sea, off Australia. Now it's Gabon, where a new huge oil discovery made by Shell and Elf Gabon contains recoverable reserves *conservatively* estimated at 439 million barrels. Production is running at 50,000 b/d and is slated to increase to 120,000 b/d next year. Gabon should be pushing for a sizable 43% leap to 250,000 b/d (from 175,000 b/d in 1989's second half) when Opec meets soon to discuss 1990 quotes.

At the same time, Norway's Giant Gullfaks oil field has been uprated by as much as 30%, yielding an extra 400 million barrels.

The battle for market share has barely begun. With new supplies sprouting all over the globe, only lower prices will accommodate the increased selling and ultimately end Opec's artificial supply restraint.

**STRATEGY:** Cover December '89 shorts at market and liquidate all outstanding put options.

Chart 15 — NYME Crude Light Dec '89

**SUGAR****Sugar revisited**

Since we became friendly towards sugar (*FC&CC* May 24, 1987), its price has doubled. This upward trend has been motivated by that commodity's fundamentals. Chart 16 shows that for the 1989-90 market year, consumption is projected to continue outstripping production. In consequence, ending stocks as a percentage of consumption are projected to be lower than at any time since 1974-75, when they were 22.7%. This projection suggests that sugar prices will continue to work their way upward during the new market year (September 1989 to August 1990).

In addition to the bullish fundamentals displayed in Chart 16, we should mention that the US announced last week that it would extend its quota year and increase its new quotas. This will allow some countries that haven't filled their 1988-89 quotas extra time for quota filling. It will also allow for increased total shipments to the US on the new quotas.

This will result in an additional 135,000 tons of "world sugar" being shipped to the US in the final quarter of 1989. In consequence, these quota changes will add a marginal bullish touch to the world market.

The fact that the fundamentals continue to point towards higher prices does not imply that this market has been, or will be, easy to trade. Indeed, over the past few months, volatility has been relatively high as buyers practice the art of brinksmanship. How many times has India rattled the market by announcing that it was "going to buy," and then announcing that it wasn't "going to buy?" This brinksmanship has, of course, kept the speculators at bay, which has kept the market from getting wound up. However, as time goes on, consumption continues to outstrip production, and the market becomes fundamentally tighter and tighter. This increases the probability that the brinksmen will eventually be unable

to keep the speculators at bay any longer. Then, the market will get would up.

Unfortunately, the short-term picture is not as clear as that for the long term. We are concerned that the spread between "whites" and "raws" has narrowed sharply. Moreover, the October/March spread has narrowed since the middle of August. Both of these spread relationships have our attention and are causing us worry because they are not typically associated with a strong market. So much for our short-term worries.

For the brighter side of the short-term picture, consider that during the three-week period from September 26 to October 12, the March contract has increased in price 14 of the last 15 years.

**STRATEGY:** You are long the March contract per the Hotline Update of August 29. Retain stops at 11.75, close only.

– Dr. Steve H. Hanke

**Chart 16**  
World Sugar: Production, Consumption, Stocks

Mkt. Year	Production	Consumption	Ending Stocks	
			Quantity	% of Consumption
85/86	98.769	100.473	38.973	38.79
86/87	104.183	105.572	36.181	34.27
87/88	104.587	107.481	32.710	30.43
88/89 est.	106.644	108.641	30.718	28.27
89/90 proj.	107.475	109.425	27.448	25.08

Note: All figures in millions of tons, unless otherwise specified.

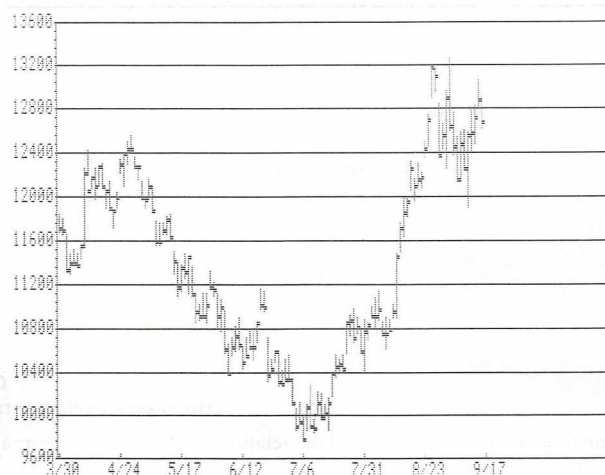
**COPPER**

**Prices heading higher**

Copper users remain expectant of strike activities in Papua New Guinea, Peru, British Columbia, and Chile. Even if all the strikes are soon settled (as is already the case in Peru and Chile), copper supplies are too uncomfortably low to satisfy normal fall/winter demand. Reflecting this convenience premium of holding inventories, backwardation in New York, has widened to almost 10¢/lb.

**STRATEGY:** Prices should head higher as the market launches a new attempt to break the \$1.60/lb. peak. Roll over September '89 long positions to December '89 and place stops at 119.00, close only.

**Chart 18 – COMEX Copper Dec '89**



**FRIEDBERG CAPITAL MARKETS**

**Cooper Companies**

After sustaining heavy losses in the mid-1980s, Cooper Companies began to dispose of all of its operating businesses and other assets. Over the past two years, this liquidation has left the company with basically no business. In fact, Cooper Companies is at this time a corporate shell.

The best available information shows that the company has \$210 million in cash, of which \$30 million is in escrow. The only significant debt that Cooper has is a \$113.8 million convertible bond issue, which trades at 62.25 cents on the dollar.

The company recently increased the bond coupon from 8% to 10%, and it will reset it again on June 15, 1991, to a

rate that will make the bonds trade at 75 or higher but in no case will the coupon be less than 10% or more than 13%.

Cooper Cos. has a minimum estimated tax loss carry-forward of \$125 million. The company has elected Arthur Bass, one of the prime movers of American Express, President and CEO. At this time, the convertible bonds are well covered; net liquid assets of \$180 million against total debt \$113.8 million (and only \$69.7 million at market value). The company is now in a position to purchase an operating company and use its tax loss carry forward to shelter profits, thus increasing retained earnings and the company's own creditworthiness.

The risks are that the company could either issue more debt or borrow funds that would rank senior to the convertible bonds. Another risk is the lack of an operating business — at least for now. Finally there is a bitter proxy dispute between the former and present management, which could dissipate a good deal of the company's cash and management's energies.

We offer the following US\$ denominated bond:  
**Cooper Companies 10 5/8%**  
 Due: 1/3/2005  
 Price: \$62 1/4  
 Semi-annual yield to maturity: 18.69%  
 CV to 36.43 shares/1000 at \$27.45 per share.  
 Current stock price: \$3 1/8.

Friedberg Capital Markets is a division of Friedberg Mercantile Group, a securities dealer and futures commission merchant. Friedberg Mercantile Group and Friedberg Commodity Management Inc. are under common beneficial ownership, control and management.

**Chart 19**  
**Foreign Currency Bonds**

Date: September 14, 1989  
 We offer the following bonds subject to change without prior notice:  
 Min. a/c USS5000.

PAY ISSUER/MTY./DATE/COUPON	BID	OFFER	CURRENT ANNUAL YIELD TO MTY	LAST PAY DATE	NEXT PAY DATE
<b>CANADIAN DOLLAR DENOMINATED BONDS</b>					
GOVERNMENT OF CANADA (semi annual) 01/02/90 13 1/4%	100.18	100.52	11.75	01/08/89-01/02/90	
<b>NEW ZEALAND DOLLAR DENOMINATED BONDS</b>					
TORONTO DOMINION BANK 02/04/90 18% RSP eligible	100	3/4-	-		04/02/89-04/02/90
MCDONALD'S (semi annual) 15/08/90 16 3/4%	101	5/8-	102 5/8	13.96	15/08/89-15/02/90
TOURIST HOTEL (N.Z.) 04/06/93 zero coupon	60	1/2-	62 1/2	13.53	matures 04/06/93
<b>AUSTRALIAN DOLLAR DENOMINATED BONDS</b>					
COMMONWEALTH BANK OF AUSTRALIA 01/01/94 14%	98	1/8	-	-	01/07/89-01/07/90
WORLD BANK 15/03/93 12 3/4% RSP eligible	95	5/8-	96 5/8	13.96	15/03/89-15/03/90
CAN.IMP.BANK OF COMMERCE 13/03/91 13% RSP eligible	95	-	96	16.06	13/03/89-13/03/90
<b>DANISH KRONER DENOMINATED BONDS</b>					
STOCKHOLM 10/11/91 10 5/8%	101	-	101 3/4	9.65	10/11/89-10/11/90
<b>BRITISH POUNDS DENOMINATED BONDS</b>					
KRM of SWEDEN 14/4/93 9 3/8%	93	1/4-	94	11.48	14/04/89-14/04/90
<b>DEUTSCHE MARK DENOMINATED BONDS</b>					
QUEBEC HYDRO 5 1/2% 1/5/96RSP eligible	91	-	92	7.05	01/05/89-01/05/90
<b>SWISS FRANC DENOMINATED BONDS</b>					
GOVT. OF AUSTRALIA 30/10/98 5% JAPANESE YEN DENOMINATED BONDS	93	-	94	5.87	30/10/89-30/10/90
<b>GOVT. OF CANADA</b>					
23/7/93 5 5/8% RSP eligible	100	3/4-	101 1/2	5.18	23/07/89-23/07/90
<b>U.S. DOLLAR DENOMINATED FIXED CONVERTIBLE BONDS</b>					
PACIFIC SCIENTIFIC 7 3/4% 15/06/03(semi) CV \$538 p/sh	69	-	-	-	15/06/89-15/12/89
SUNRISE MEDICAL INC. 7.25% 26/6/96 CV \$517 5/8 p/sh	75	-	78	12.47	26/06/89-26/06/90
ALLIANT COMPUTER 7.25% 15/05/12(semi) CV \$539.75 p/sh	47	-	49 1/4	15.95	15/05/89-15/11/90
COOPER CO'S. 10 5/8% 01/03/05(semi) CV \$27.45 p/sh call in 1995 @100	60	1/4-	62 1/4	18.69	01/09/89-01/03/90
COEUR D'ALENE 6% 10/06/02 CV \$26.55 p/sh call in 1990 @ 103	84	1/8-	86 1/8	7.75	10/06/89-10/06/90
<b>U.S. DOLLAR DENOMINATED FIXED RATE BONDS</b>					
ALBERTA 7 3/8% 9/12/91 RSP eligible	97	3/8-	98 1/8	8.31	09/12/89-09/12/89
SOUTHBANK CORP. 10 7/8% 1/11/09 (semi)					N/A
<b>U.S. DOLLAR DENOMINATED FLOATING RATE NOTES</b>					
UNITED KINGDOM 24/9/96 3 mo. LIBID-1/8 (qly)	100.02	-	100.32	9 1/8%	28/06/89-28/09/89
REPUBLIC OF ITALY 30/4/93 3 mo Limesan(qly)	99.50	-	99.90	8 3/4%	31/07/89-31/10/89
REPUBLIC OF PORTUGAL 8/12/93 6 mo LIBOR +5 B.P.(semi)	99.92	-	100.22	9.3%	08/06/89-08/12/89
BANCO CENTRAL DE BRAZIL 15/10/99 6 mo LIBOR +13/16 (semi) *	61	-	63	11 5/16%	17/04/89-15/10/89
				** 22.04%	

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

\*\* Yield to maturity

\* amortized: 1/4 of principal paid semi-annually starting 1993.

**Chart 20**  
**Breakeven exchange rates for US\$ - based investor**

This analysis shows a "snapshot" of the relationship between interest rate differentials and rates of exchange. The breakeven rate measures how far the foreign currency has to devalue (for NZ\$, A\$, DKr) or revalue (for DM, SF, JY) before the interest rate advantage/disadvantage is overcome by currency depreciation/appreciation. September 14, 1989

	U.S. \$	NEW ZEALAND \$	AUSTRALIAN \$	DEUTSCHEMARK	SWISS FRANC	JAPANESE YEN	DANISH KRONER
1 year	7.93%	McDonald's 16% 15/8/90 yields 13.96% (.559 NZ/US)					
2 year	8.05%		CIBC 13% 13/3/91 yields 16.06% (.672 A\$/US)				Stockholm 10% 10/11/91, yields 9.65% (7.87 US/Dkr)
4 year	8.04%	Tourist Hotel 0% 4/6/93, yields 13.53% (.484 NZ/US)	World Bank 12 3/4% 15/3/93 yields 13.96% (.627 A\$/US)			Canada 5% 23/7/93, yields 5.18% (125 US/JY)	
7 year	8.08%			Hydro Quebec 5 1/2% 1/5/96 yields 7.05% (7.84 US/DM)			
9 year	8.09%				Australia 5% 30/10/98 yields 5.87% (1.41 US/SF)		
Spot Exchange Rate	N/A	.590	.7763	1.9662	1.6965	146.45	7.639

\*\*For example, in parentheses, since a US\$ based investor would receive 603 basis points (1396-793) by holding the McDonald's NZ\$ bond, the NZ\$ can depreciate to .559 NZ/US from the present spot exchange

rate of .590 NZ/US over the next 1 year for the NZ\$ investment to break even with current US\$ rates of interest. Assumes that bonds are held to maturity, and coupons are reinvested.

**FOREX RATES & UPDATE**

<u>Currency</u>	<u>Spot</u>	<u>3-Month</u>	<u>12-Month</u>	<u>Comments vis à vis US\$</u>	<u>Comments vis à vis DM (Spot DM: 1.9960)</u>
Australian dollar	.7700-.7710	.7527-.7542	.7123-.7148	Neutral	Neutral
Belgian franc	41.80-41.90	41.75-41.78	41.68-41.77	Remain short	Neutral
Danish krone	7.7575-7.7625	7.7735-7.7820	7.8345-7.8535	Remain short	Neutral
Dutch guilder	2.2465-2.2475	2.2404-2.2418	2.2245-2.2465	Remain short	Neutral
Greek drachma	172.45-172.55	176.45-180.55	187.45-201.55	Remain short	Remain short
Hong Kong dollar	7.8080-7.8090	7.8065-7.8100	7.8080-7.8190	Neutral	Remain long
Irish punt	1.3330-1.3345	1.3280-1.3305	1.3100-1.3145	Remain short	Neutral
Italian lira	1436-1437	1447-1449	1480-1486	Remain short	Neutral
Kuwaiti dinar	.30080-.30120	.30030-.30090	.29860-.30040	Remain short	Neutral
Malaysian ringgit	2.7060-2.7090	2.6985-2.7040	2.6760-2.6860	Neutral	Neutral
New Zealand dollar	.5870-.5880	.5800-.5820	.5610-.5650	Neutral	Neutral
Norwegian krone	7.2450-7.2500	7.2790-7.2870	7.3700-7.3865	Remain short	Neutral
Portugese escudo	167.00-167.40	168.90-169.65	175.40-179.00	Remain short	Neutral
Saudi Arabian riyal	3.7500-3.7505	3.7480-3.7500	3.7475-3.7495	Remain short	Remain short
Singapore dollar	1.9850-1.9870	1.9695-1.9730	1.9305-1.9405	Neutral	Neutral
Spanish peseta	124.75-124.85	126.25-126.55	130.10-130.55	Remain short	Neutral
Swedish krona	6.7175-6.7225	6.7640-6.7715	6.8895-6.9035	Remain short	Neutral

**Explanatory Notes**

\*Indicates change in recommendation from last issue.

\*\*Liquidate on the basis of DM and EMS recommendations, when and if issued on the Hotline.

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, July 25:**

Market letter is in the mail.

**Friday, July 28:**

No changes or new recommendations.

**Flash update, Tuesday, August 1, 9:45 a.m.:**

One new recommendation:

Buy September copper at market. Place initial stops at 107.00, close only.

Note that the cash yen closed in New York last night just above 137. Therefore, technically we are still short the yen. It will require a convincing close below the 137.00 level to move us to cover our position. At any rate, should you be forced to cover short position in yen, leave cross trades intact and follow the market letter stop of 70 yen to the DM.

**Second flash update, Tuesday, August 1, 10:50 a.m.:**

Raise stops in long October sugar positions to 1414, good anytime. Now a repeat of our first flash update, at 9:45 a.m.

Buy September Copper at market. Place initial stops at 107.00, close only.

Note that the cash yen closed in New York last night just above 137.00. Therefore, technically we are still short the yen. It will require a convincing close below the 137.00 level to move us to cover our position. At any rate, should you be forced to cover short positions in yen, leave cross trades intact and follow the market letter stop of 70 yen to the DM.

**Friday, August 3:**

A wrap-up of the week's activities:

As per our flash of Tuesday, August 1, you are long September copper with stops at 107.00, close only.

Also note that you are stopped out of October sugar at 1414, as per our flash on Tuesday a.m.

**Tuesday, August 8:**

One new recommendation:

For the opening tomorrow morning, Wednesday, August 9 only. If the high of the opening range in September JY is 7230 or lower, sell September JY at market, risking 7401 good anytime.

**Flash update, Wednesday, August 9, 4:15 p.m.:**

1. As per yesterday's update, you sold short September. JY at today's opening with stops at 7401, good anytime.
2. One new recommendation: Sell September Eurodollar at market, risking 9182, close only.

**Friday, August 11:**

A recap of the week's activities:

As per Tuesday's update advice, you sold September JY at approximately 7210 with stops at 7401, good anytime.

As per Wednesday's flash update, you sold September Eurodollar risking 9182, close only.

**Tuesday, August 15:**

No changes or new recommendations.

**Friday, August 18:**

No changes or new recommendations.

**Tuesday, August 22:**

We would like to recommend a new cross trade. Buy three December DM against the sale of two December BP. Place initial stops at 312 DM to BP, basis spot New York close only.

**Friday, August 25:**

A review of new positions suggested over the hotline still current since our last market letter of July 23.

1. Short September JY at approximately 7210 with stops at 7401, good anytime as per our recommendation August 8.
2. One new cross trade: long three December DM against short two December BP with a stop at 312 DM to BP, basis spot, New York close only as per August 22.
3. Long September copper at around 111.90 as per August 1. Raise stops to 125.00, close only.
4. Short September Eurodollar at approximately 9137, risking 9182, close only as per August 9.

**Tuesday, August 29:**

No changes or new recommendations.

**Friday, September 1:**

No changes or new recommendations.

**Flash update, Tuesday, September 5, 12:50 p.m.:**

Buy March sugar at market, risking 1175, close only. This will replace the regular Tuesday update if no other changes.

**Tuesday, September 5:**

As per our flash update of today 12:50 p.m., you are long March sugar at approximately 1242 with stops at 1175, close only.

Cover short September Eurodollar positions at market, accepting profits.

**Friday, September 8:**

A wrapup of the week's activities:

1. As per our flash update of Tuesday, you are long March sugar at approximately 1242 with stops at 1175, close only.
2. As per our recommendation of Tuesday, you have covered short September Eurodollar positions, accepting profits.

**Tuesday, September 12:**

No changes or new recommendations.

**Friday, September 15:**

A review of new positions suggested over the hotline and still current since our last market letter of July 23.

1. Short September yen at approximately 7210 with stops at 7401, good anytime as per our recommendation of August 8.
2. One new cross trade: long 3 December DM against short 2 December BP with a stop at 312 DM to BP, basis spot New York close only, as per August 22.
3. Long September copper at around 111.90 as per August 1 with stops at 125.00, close only.
4. Long March sugar at approximately 1242 with stops at 1175, close only.

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