

# FRIEDBERG'S

## COMMODITY & CURRENCY COMMENTS

Friedberg Commodity Management Inc.



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### Earthquake!

The Land of the Rising Sun is soon to be renamed the Land of the Rising Interest Rates. And rising interest rates will produce a financial earthquake whose shock waves will reverberate throughout the world.

The dramatic pace of monetization (see Chart 1) of the Japanese economy had gone on for so long that even the staunchest monetarists began to believe that Japan Inc. was not a member of Earth, and, as such, could repeal all laws of economics. Euphemistically called "excess liquidity," rising monetization created wealth *ex nihilo*: Soaring real estate and stock prices accompanied by incredibly low inflation and interest rates, topped by a growing and humongous current account surplus. But whether it be in Peru or US or Japan, common sense is bound to catch up: "There ain't no free lunch."

Blasting those who hinted that "all's not well" and who called for rising interest rates, the powerful Mr. Makoto Utsumi, Vice Minister of Finance for International Affairs said "needless to say, price stability is a prerequisite for economic growth... But I am a little bit concerned that there are those who treat so-called 'asset inflation,' that is to say, the rise in land and stock prices, as an important part of the inflation. Asset inflation is, by nature, different from inflation in the proper sense of the word.

"Confusion in the diagnosis of the illness would cause confusion in choosing the right remedy," said Mr. Utsumi. Such "misleading discussion might create some kind of ambiguity" about policy and "would eventually lead to instability in the markets.

"I think that we should avoid any kind of ambiguity concerning the course of our fiscal and monetary policies which might lead to market instability."

Typical of the Ministry of Finance, this bureaucrat (trained as a lawyer, not as an economist, thank goodness) cannot find anything wrong with the virtuous circle of cheap money and soaring asset prices; in his words "asset inflation is, by nature, different from inflation in the proper sense of the word." We wish Mr. Yashumi Mieno, governor of the Bank of Japan, well in his forthcoming lectures to Mr. Utsumi and Co. on Economics 101.

It is a fact, however, that inflation in non-tradeables is far more likely to appear first than inflation in tradeables when the exchange rate is rising or even relatively stable (as was the

case with the yen (see Chart 2) and when institutional arrangements channel credit ("excess liquidity") to real estate and stock prices rather than to consumption. Favorable international perceptions of Japan Inc., aided by the extraordinary prowess of its export sector, kept the exchange rate inordinately strong, which in turn "anchored" tradeable domestic prices to international prices. Despite rapid monetary expansion, "inflation in the proper sense of the word," i.e., consumer prices increases, was kept down to a remarkable 1.1% per annum in the past five years.

But there are limits to this wunderkraft. If Mr. Utsumi refuses to heed the signs of asset inflation and what they are *really* telling — that inflation is in truth out of control — there are at least two other indicators that have begun to flash red. The first is Japan's collapsing trade surplus; the second is the yen's weakness.

Chart 3 depicts a rare phenomenon: Japan's trade surplus in January has plunged to nearly *a tenth* of the level a year ago, the largest monthly year-to-year drop in 11 years! And it was no flash in the pan: January's drop follows a 36% drop in December and a 46% drop in November. The overheated economy caused exports to fall 3.8% to \$18.62 billion and imports to rise a solid 13% to \$18.28 billion. Again, Economics 101. Given a relatively fixed rate of exchange,

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With contributions by Albert D. Friedberg, Dr. Steve H. Hanke, and Michael D. Hart.

inflation will make its first outward appearance through a deteriorating trade/current account surplus rather than through a rise in prices. Short of massive monetary tightening, Japan is well on its way to recording its first trade deficit in 27 years.

The second sign that Japan has reached the limits of monetization and is about to experience some real price inflation can be found in the falling yen.

As our readers know, we have been advising for the past six months a cross trade made up of a short yen position and a long Deutschemark position (and later, a long Swiss franc and long lire position, see "The weakening DM"). This extremely profitable trade (see Charts 4 and 5) benefitted primarily from the strength of the European currencies *vis à vis* the US dollar — while the yen remained locked in a tight \$/yen 142-146 range.

In recent days, this tight range has been broken, and the yen has weakened to the lowest point since the late summer of 1989 (see Chart 6). What is more ominous, the \$/yen has broken out of a massive triangle that threatens to take it to the 165-175 area, if allowed to depreciate. The long period of price stability — purchased with a strong yen — is about to end.

The Ministry of Finance's refusal to see genuine inflation in rampant money supply growth (because it was being monetized) and soaring asset inflation (because it is not inflation in the proper sense of the word) will cost the country and the world dearly.

Due to pressure from the Ministry of Finance, the Bank of Japan's monetary policy has become increasingly easier. Whereas last month we commented that the negative yield curve (one over 150 basis points) had narrowed to 50 basis points, at this time, the yield curve is practically flat, primarily a result of a nervous and skeptical bond market (see Chart 7). In fact, short-term rates continue to hover around 7% to 7½% while the 10-year government issue traded down to a 7.09% yield in mid-week before being "forced up" by MOF purchase to a 6.86% yield. Unnaturally low interest rates are stimulating strong money supply expansion with the latest year-over-year figures at 11.5%.

Thus far, rapidly falling stock prices have provided the MOF with enough ammunition to frighten into submission

the (economically illiterate) political leadership. Sooner or later, however, a collapsing bond market and a collapsing yen will inflict such pain that the MOF will relent. At that point, the Bank of Japan will face a terrified financial environment and will have no choice but to "leapfrog" market rates. Naturally, the longer it waits, the higher will the discount rate be hoisted. *If the BOJ were given free rein today, it would probably have to raise three-month deposit rates to somewhere around 8½% to 9% — considering the level of long-term rates and, also, Eurodollar rates (8¼%) and Euro DM rates (8⅜%) — to restore a semblance of confidence.*

The impasse between the MOF and the BOJ is not likely to be resolved promptly. Rather, as we suggested, the market will cause the yen to slide and long-term yields to rise until a crisis will force the authorities to regain control by recognizing that money has been "too cheap" for "too long."

**STRATEGY:** *In this scenario of much higher Japanese interest rates:*

- 1) *Their bond market will go much lower. We are short the 10-year 6% government bond traded on the LIFFE (face value ¥ 100,000,000) with stops at 96.75, basis June '90, close only (see Hotline).*
- 2) *We remain short yen versus our long positions in Swiss francs, Italian lire and British pounds.*
- 3) *The Japanese stock market, yielding a miserly ½% per annum, has begun what we believe will be the most vicious bear market in its history. The ultimate lows could see stock prices fall 60% to 90% from the all-time high above 39,000. We advise purchasing Nikkei Dow Jones puts, still showing extremely low implied volatilities.*
- 4) *Although, admittedly, rising interest rates in Japan will affect rates in the US, Canada, and Europe, their impact should not be overestimated. Rising interest rates in Japan will be required to halt the rapidly depreciating yen as well as accelerating inflation; therefore, their impact on worldwide rates will be muted but only after Japan's predicament is fully understood.*

*The important trading implication is that if one wants to capitalize on rising Japanese interest rates, one has to sell Japanese long bonds, not US or Canadian long bonds.*

Chart 1

MONETIZATION (M2/GNP) IN JAPAN AND US

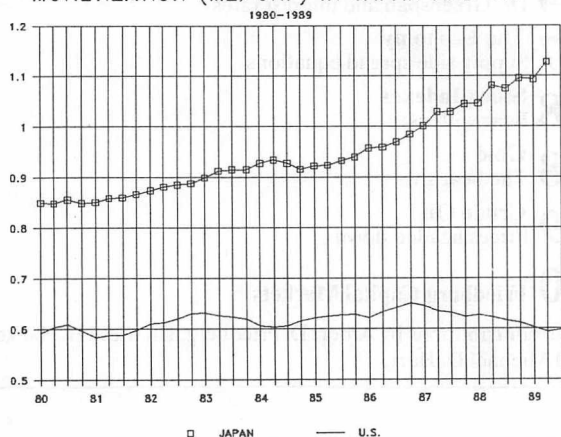


Chart 2

AVERAGE MARKET RATE OF JAPANESE YEN

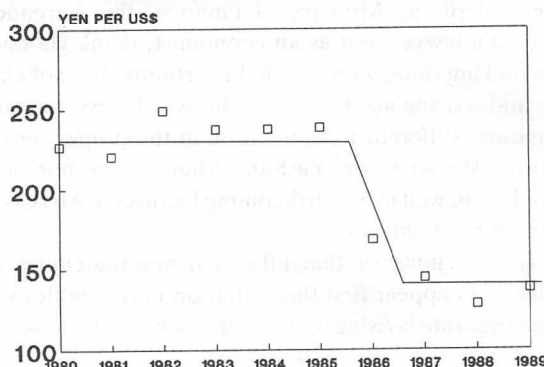


Chart 3

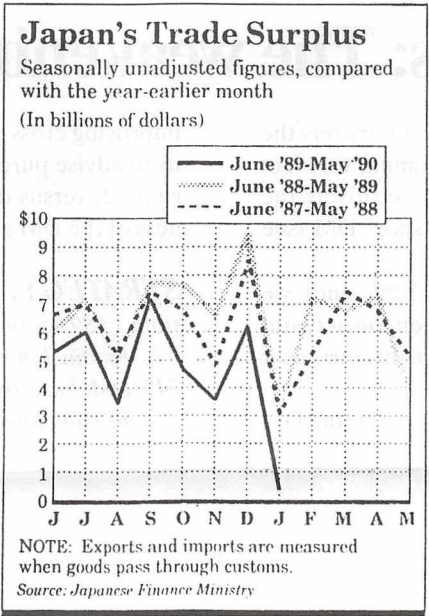


Chart 4  
Deutschemark/Yen

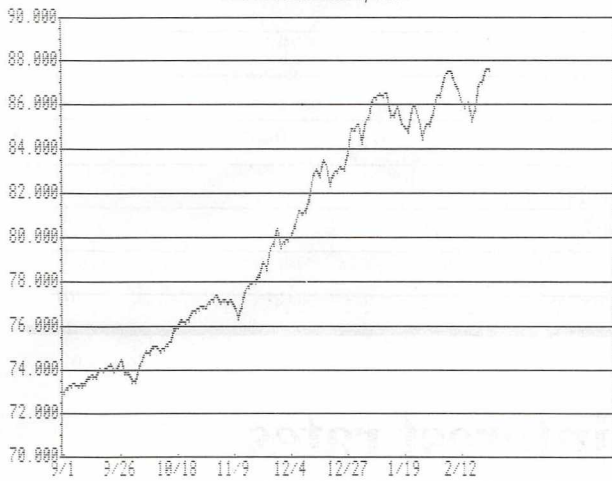


Chart 5  
Swiss franc/yen

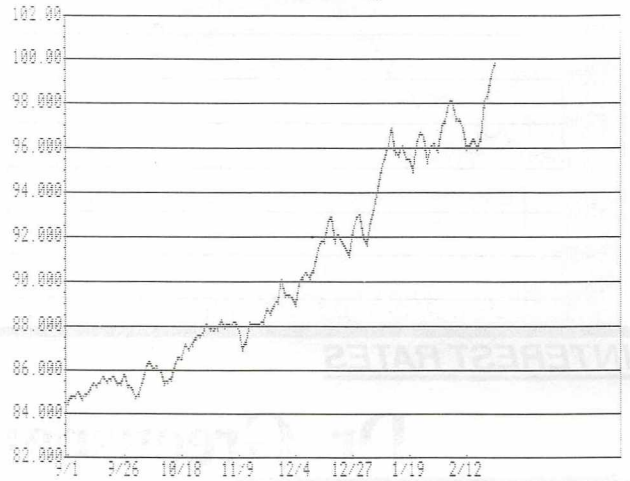


Chart 6  
Japanese Yen

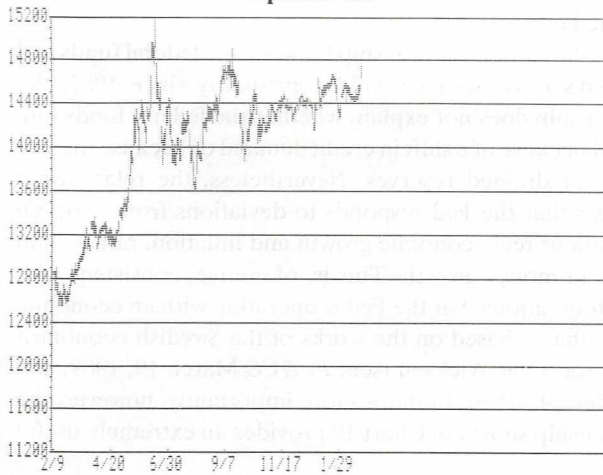


Chart 7  
Japanese Government Bond - Mar 90 (LIFFE)



**CURRENCIES****Crosses: The weakening DM**

Uncertainty regarding the proper method and ultimately the proper exchange rate to be used in the upcoming German monetary reunification has begun to impact negatively the DM, favoring our cross trade, long Swissie/short DM (see Chart 8) and long lire/short DM.

The lira, at 739.50 LIT/DM, has risen 1.2% since we advised its purchase, while the forward position, on account of the high interest rates, has given us an extra lift, turning it into a handsome trade.

Finally, Sterling continues to appreciate *vis à vis* the DM (see Chart 9) due to the Bank's "hard line" policy. The

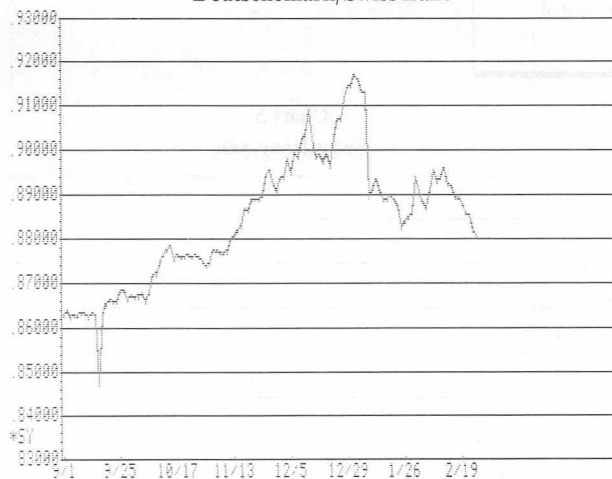
improving cross and sizable forward discount have prompted us to advise purchasing Sterling (see Hotline Update of February 2) versus dollars, to best capitalize on the twin weakness of the DM and the US dollar.

**STRATEGY:** Retain long Swiss franc/short DM; lower stops to 89.55, basis spot, London close.

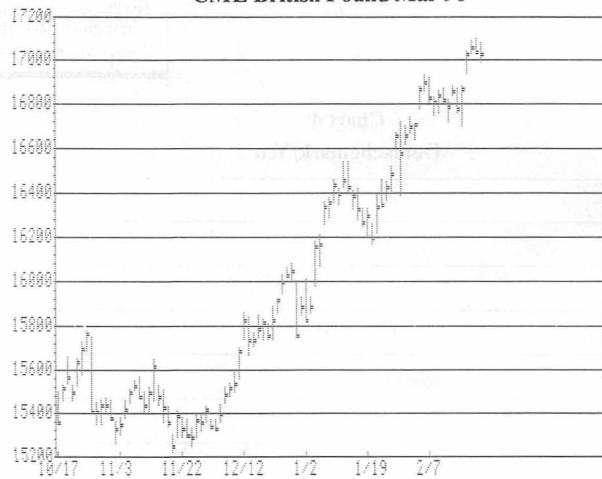
Retain long lire/short DM spread; place stops at LIT 745/DM, basis spot, London close.

Remain long June '89 British pound; raise stops to 162.00 close only.

**Chart 8**  
Deutschemark/Swiss franc



**Chart 9**  
CME British Pound Mar 90

**INTEREST RATES****Dr. Greenspan and interest rates**

Last Thursday, Federal Reserve Board Chairman Alan Greenspan completed a series of appearances before Congress. He presented the Federal Reserve Board's annual *Monetary Policy Report to Congress* and accompanying Humphrey-Hawkins testimony. Several years ago, Dr. Mickey D. Levy, one of the nation's most astute observers of interest rate developments, convinced us that the Fed's February reports and the Chairman's testimony, properly understood, provide the key to understanding interest rate trends. In consequence, we present our analysis of the Fed's February 1990 materials.

Since 1982, monetary policy can be characterized as discretionary. The pattern that has emerged is contained in Chart 10. The Fed's projections reflect its economic objectives as well as what it anticipates will actually occur. When real GNP growth and the CPI deflator were above the Fed's central tendency range, the federal funds rate increased from

the end of the previous period. Conversely, the federal funds rate dropped when economic growth and inflation were below the Fed's forecast.

Although the relationship between the federal funds and the Fed's forecasts have held consistently since 1982, the relationship does not explain whether the federal funds rate moved because of a shift in credit demand or because the Fed added or drained reserves. Nevertheless, the relationship suggests that the Fed responds to deviations from expectations about real economic growth and inflation, rather than trends in money growth. This is, of course, consistent with our observations that the Fed is operating with an economic model that is based on the works of the Swedish economist Professor Knut Wicksell (see: *FC&CC* March 19, 1989, and October 29, 1989). Perhaps more importantly, however, the relationship shown in Chart 10 provides an extremely useful

framework for explaining the direction of interest rates.

**Implications:** As we point out in "Supply-side equations" (see accompanying article), there is considerable evidence to suggest that the Fed's projection for real growth (1.75-2.0) is on target. If this occurs and the inflation rate falls in the 4.0% to 4.5% range, we conclude that the federal funds rate will be about 8.45% in December 1990 (the current rate is about 8.3%). However, inflation might well fall below the Fed's projection. (Note the fall off in the inflation rate from the first to the second half of 1989. Also, see our analysis in "Professor Wicksell Revisited" *FC&CC* October 29, 1989.)

If inflation is lower than the Fed's projection and real growth is in the target range, the federal funds rate in December 1990 will be somewhat below the December 1989 rate (8.45%). However, a word of caution is in order about this last scenario: even if the inflation is lower than the projections and real growth is in the target range, the Fed will be reluctant to allow the funds rate to fall below the December 1989 level by December 1990, if the dollar should come under downward pressure and, at the same time, capacity utilization rates in manufacturing are healthy.

— Dr. Steve H. Hanke

Chart 10  
Federal Reserve Projections, Actual Economic Performance, and Interest Rate Trends

	Percentage Change, Fourth Quarter to Fourth Quarter:						Federal Funds Rate	
	Real GNP		Nominal GNP		CPI Deflator		Percentage	
	Fed <sup>a</sup> Projection	Actual	Fed Projection	Actual	Fed Projection	Actual	Levels Dec-Dec	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 1/2	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	2.4	6 1/2-7	6.4	4 1/2-5	3.8	8.75-8.45	-.3
Memo:								
1989	1st half <sup>d</sup>	3.1		7.5		4.3	8.75-9.5	+ .75
1989	2nd half <sup>e</sup>	1.7		5.3		3.4	9.5-8.45	-1.05
1990	1 3/4-2		5 1/2-6 1/2		4-4 1/2		8.45-	

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.  
<sup>d</sup> Actual GNP and inflation are annualized growth rates from 1988:IV to December 1989:II; interest rates are from December 1988 to June 1989.  
<sup>e</sup> Actual GNP and inflation are annualized growth rates from 1989:II to 1989:IV; interest rates are from June 1989 to December 1989.

**CURRENCIES**

**Reform begins with a currency board**

by Steve Hanke and Alan Walters

The two Germans have agreed to begin discussions about crafting a currency reform. This represents a tiny step along what promises to be a bumpy road.

Chancellor Helmut Kohl's pre-emptive strike on currency reform will, no doubt, provide the starting point for deliberations. The Chancellor proposes a quick switch from

two German Marks to one. Such a currency reform would entail the abolition of East Germany's central bank and its unconvertible soft currency. In exchange, the East Germans would accept West Germany's Bundesbank as the sole purveyor of its monetary policy and the D-mark as its legal tender. This proposal has given the Bundesbank's President,

Mr. Karl Otto Pöhl, and some East German officials considerable discomfort.

But the tensions created by the proposed switch are unnecessary. There is an alternative that should satisfy both Mr. Kohl and Mr. Pöhl, as well as the East Germans.

The currency reform would require that East Germany's central bank be replaced by a currency board. This new institution would guarantee East German monetary stability and establish a fully convertible East German Mark. Thus, the Chancellor's objectives would be achieved. An East German currency board would not affect the Bundesbank's policies and would lay the foundation for a monetary union and eventual German reunification. Mr. Pöhl's concerns would be addressed and the East German Mark would be retained. Thus, the East Germans would be able to save face.

Although currency boards appear to be something new, they are not. Currency boards were ubiquitous in the colonial regimes of Africa, Asia and the Caribbean. But as colonies became independent in the 1950s and 1960s, they generally eschewed the currency board system and formed central banks. Perception, rather than performance, engendered the demise of the boards: they were regarded as colonial instruments of exploitation.

This was an unfortunate misconception. Where currency boards survive, for example in Singapore and Hong Kong, they have prevented exploitation by currency debase-ment. Indeed, these countries have been bastions of stability in a world of inflationary expropriation.

The principle attributes of a currency board are:

- Issuance of domestic currency which is readily convertible into a foreign-reserve currency at a specified and fixed rate.
- Domestic currency backed by liquid reserves held by a board and denominated in a foreign-reserve currency.
- Reserves equal to or greater than the value of the domestic currency issued. The discipline of convertibility at a fixed rate and reserve-currency backing establish reliability and confidence.

To establish a hard East German Mark, East Germany should convert its central bank into a currency board. The board would recall old East German Marks and replace them with new ones. The new East German Marks would be fully backed by interest-bearing, West German Government bills and D-Mark notes. Moreover, the new East German Marks would be fully convertible and as good as D-marks because the East German currency board would exchange new East German Marks at a fixed rate for D-marks.

The critical question is: at what level should the exchange rate to be fixed? Too high a rate (such as the 1:1 official rate) would render East German industry almost uncompetitive. Real wages would be relatively high, but few

workers would enjoy them since employment would be scarce. Similarly, too low a rate (say 1:10) would result in a shortage of labour as the world would rush to employ the low-wage workers in East Germany.

In our view, it would be best to fix the new East German Mark rate near the present "free" rate (1:6). It is true that at this rate holders of East German Marks would not receive a subsidy from West Germany as a consequence of the reform. However, transparency dictates that any subsidy should be an explicit one from the West German Government and the country's voters to residents of East Germany, rather than an implicit one facilitated through a currency reform.

A currency reform along these lines would assist the East Germans in their attempt to escape the grim realities of socialism. The East German public purse would be out of reach from plundering politicians since they would no longer have access to East German Mark printing presses. Hence, East Germans would enjoy roughly the same low inflation and interest rates as West Germans. In consequence, East Germans would be as willing to hold new East German Marks as D-marks.

With an East German currency board, foreign investors would be able to convert new East German Marks into a hard currency and repatriate profits earned in East Germany. This convertibility feature would facilitate trade, establish investor confidence and encourage the inflow of foreign capital. Non-governmental linkages between East Germans and international capital markets would be established. These linkages would promote the creation of international bank branches in East Germany. Such branches would give the East Germans access to large pools of competitively priced capital and international expertise. Other advantages include economy, simplicity and automatism.

Chancellor Kohl is correct. The East German central bank instills little confidence and produces unconvertible soft Marks. Thus, its existence jeopardises liberal economic reforms. Mr. Pöhl is also correct. An immediate monetary union between the two Germanys would threaten the Bundesbank's autonomy and sound monetary policies. To satisfy the concerns of Mr. Kohl and Mr. Pöhl and allow the East Germans to retain a sovereign monetary institution until the two Germanys are reunified, an East German currency board must be established immediately.

*The authors are professors at The Johns Hopkins University in Baltimore. Sir Alan Walters, until recently, was Prime Minister Margaret Thatcher's personal economic adviser.*

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**THE ECONOMY**

# Supply-side spread equations

In the January 28, 1990, issue of *FC&CC*, we presented a yield curve equation. We then used it to forecast a 1.65% GNP growth rate for the 1990.1 - 1991.1 period. Recall that this forecast and the logic behind it are of particular importance because the neo-Wicksellians at the Fed monitor the yield curve carefully and use changes in it to alter monetary policy.

We, too, keep our eye on the yield curve. In addition, we monitor the real side of the economy. To do this, we have developed the supply-side spread model. Supply-side spreads are calculated by adding year-over-year changes in prices (CPI) to changes in productivity (output per worker hour) and subtracting changes in unit labor costs.

The structural design of the spread model is straightforward. The spread represents the difference between the output (value) side of the economy and the input (cost) side of the economy. Thus, positive spreads suggest that value (the change in prices plus productivity) is increasing faster than the costs (labor costs). In consequence, a positive and widening spread signals accelerating growth. Whereas, a narrowing spread signals a slow down.

Chart 11 indicates that the spreads for the economy have been narrowing. Hence, we can anticipate that the economy

will slow in relation to its past growth. The question is: How great will the slowdown be?

To determine this, we present, for the first time, a supply-side equation. This equation is given in Chart 12. It tells us that when the spread is zero, we can anticipate that the next year's GNP growth will be 1.96%. As the spread becomes positive, growth must be added to 1.96% to obtain a forecast for the next year. And as the spread becomes negative, growth must be subtracted from 1.96% to make a forecast. Given the current economy-wide spread of 0.1%, we obtain a forecast of 2.0% for GNP in the 1990.1 - 1991.1 period.

**Implications:** In his testimony before the House Banking subcommittee last week, Chairman Greenspan revealed, for the first time, the Fed's GNP forecast for 1990. The range was 1.75% - 2.0%. This is, not surprisingly, very close to our range of 1.65% (yield-curve equation) to 2.0% (supply-side spread equation). In our conversations with Chairman Greenspan and Vice-Chairman Johnson, we have become more and more comfortable with our understanding of how they read the economy. The yield-curve and supply-side equations confirm our impressions.

— Dr. Steve H. Hanke

**Chart 11**  
**Supply-Side Spreads**  
**(Rates of change)**

<u>Period</u>	<u>Economy-Wide</u>
85 1	1.8%
2	1.4
3	2.7
4	2.0
86 1	4.7%
2	3.5
3	2.0
4	3.1
87 1	0.0%
2	1.8
3	4.1
4	3.8
88 1	5.8%
2	2.6
3	2.5
4	2.8
89 1	0.6%
2	2.4
3	1.3
4	0.1

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 12**  
**Supply-Side Equation**  
**(US economy-wide)**

1. The supply-side equation with 1976.1 - 1989.3 data (55 quarters) is: Change in GNP next year = 0.0196 + 0.5977 (supply-side spread in last quarter).
2. This equation explained about 43% of the variance in GNP over the 1976.1 - 1989.3 period.
3. To make a forecast of GNP for the 1990.1 - 1991.1 period, calculate the supply-side spread for 1989.4: 0.1% (see Chart 11). Substitute the spread into our supply-side equation, which yields: Change in GNP (1990.1 - 1991.1) = 0.0196 + 0.5977 (0.001) = **2.0%**.

**STOCK INDEXES**

## Bear with us

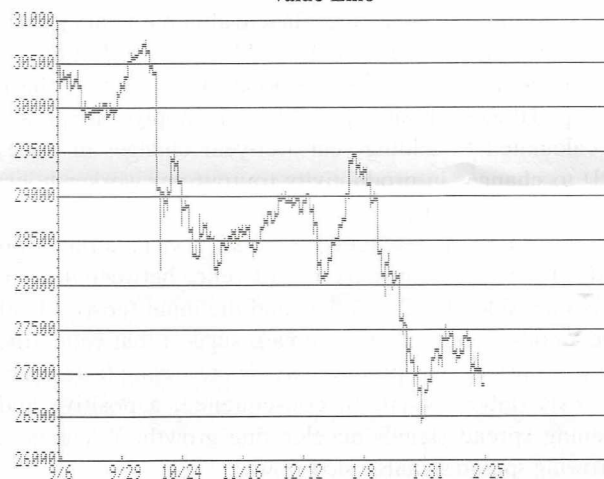
Bearish factors continue to assert themselves. Corporate profits, officially down 14% in the last quarter of 1989, seem to be heading lower in the first quarter of the year. Unpleasant surprises are not well absorbed: Digital Equipment's projection of third quarter loss, its first in 32 years, mauled the stock to \$70½, off \$5¼ for the week and a four-year low, down from the all-time high of \$199 seen in 1987. As we suggested last month, "earnings projections continue to reflect an unrealistic and unhealthy degree of optimism," not the stuff of which bull markets are born.

Collapsing breadth portends much lower prices; the modest level of odd lot short sales reassures us that sentiment has not turned as yet too negative. A necessary condition for a short, intermediate, or long-term bottom is the appearance of high volume, ideally double the recent pace; Low/average volume is fatal in a bear market. We remain attentive to significant changes in any of these areas, namely breadth (including new highs/new lows differentials), sentiment (particularly the level of odd lot short sales), and volume.

In the meantime, enjoy the declines.

**STRATEGY:** Retain short positions in March '90 (and roll over to June '90) Value Line.

Chart 13  
Value Line

**GOLD**

## The bear stirs

Gold's tottering chart formation (see Chart 14 — notice the failure of the last attempt to make new highs) joins the growing list of ominous technical and fundamental developments.

As pointed out in earlier issues, there is nothing in the Soviet and/or Eastern European "situation" that justifies a bullish position. Yet, under the pretext of ruble convertibility into gold and gold hoarding by panicky East European citizens, gold was bulled to recent highs. The gullible buyers are now holding the bag and they are becoming stale...

A new, select group of naive bulls bought the recent highs under the pretext that Mandela's South Africa was about to explode into civil war. What is apparent at this time is that negotiations will be carried out by two very astute but very well-meaning politicians; if there is "bad news" to come out, it won't be for quite some time. Furthermore, South Africa's preeminence in world production has been considerably diminished, to the point that a 10% annual shortfall (due to labor strife) will dent only 3% of world production. And in the meantime, world production continues to grow, with total supplies (including secondary scrap sources) expected to increase by 4.3% to 73.4 million ounces from 70.4 million ounces.

The enormous fall in the Comex open interest (to 123,000 contracts from a recent high of 156,000 contracts) suggests to

us that hedgers, too, have bought the bullish case and are abandoning in droves their pricing insurance.

Finally, sentiment may turn more neutral, which coupled with the market's inability to make new recovery highs increases the probability that stale bull liquidation is about to unfold. This shift in sentiment, gathered from the Bullish Consensus, served well in pinpointing *in advance* the \$70/oz. rally.

If we had to find the main catalyst for the September '89/February '90 bear market rally, we would point to the dramatic shift in gold loan activity that took place in 1989, but particularly the latter part of the year, and early 1990. Chart 15 shows that drawdowns reached their high point in 1988, pressing gold prices lower as borrowers dumped their newly borrowed gold to finance mine construction. As the rate of change tapered off and eventually turned into paybacks, downside pressure on gold prices eased. Only then was the slight change in sentiment sufficient to raise prices.

If our interpretation of open interest is correct, large hedgers are likely to once again reenter the market *as sellers*, putting renewed downside pressure on prices. It is here that the slight change in sentiment, away from outright bullishness, can turn the decline into a *roul*.

**STRATEGY:** Remain short as per our Hotline Update of February 9. Prices are heading to new lows. Retain stops at 433, basis April '90, close only.

Chart 14  
Comex Gold Apr 90

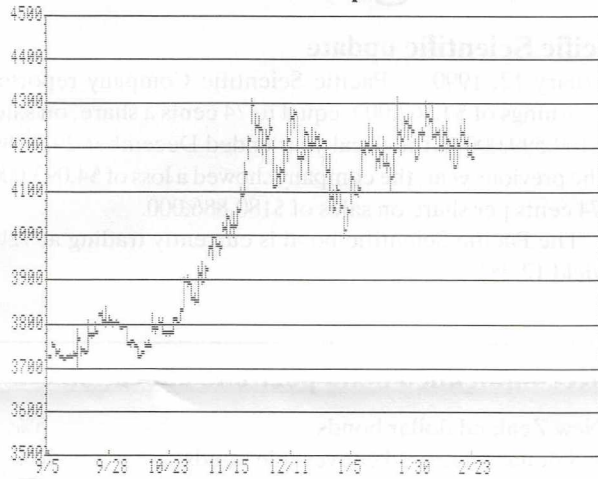


Chart 15

The Growth of Gold Loans			
	Number of new loans	Drawdowns less paybacks	Outstanding loans
1990	1	- 62.0	254.1
1989	39	49.3	316.1
1988	84	150.6	266.8
1987	36	57.5	116.2
1986	12	17.2	58.7
1985	20	38.3	41.5
1984	4	3.2	3.2

Source: RTZ

**CRUDE OIL**

**Prices headed down**

What can be more heartwarming to bears than finding a roarily bullish article on oil on the front page of *The New York Times*? Titled "Doubts in supply spur production of high oil prices — 50% rise seen in 5 years — Increases would be far bigger than previously expected." Topping the five-column article are three charts (two on the front page) depicting rising consumption, recovering prices and Opec/non-Opec shifts in production with the taunting headline: "New Worries on Oil."

The meat of the argument is that a) US and Soviet output are down by about 5%, or one million barrels/day; b) average usage is rising, with consumption expected this year to break the 11-year record of 52.3 million barrels per day (b/d); c) some of Opec's largest producers seem to be bumping against capacity.

There is little need to refute these arguments (obviously, at the top, everything looks rosy). The market has been advancing almost uninterruptedly since last summer, buoyed primarily by Far Eastern demand and production disruptions. In the process, it barely managed to better the 1987 highs, although admittedly, Opec production averaged 4 million b/d more. Sentiment, on the other hand, has become euphoric with soaring stock market multiples for contract drillers and junior oil companies (in January the TSE Oil and Gas Index almost matched the all-time high record achieved in 1980), far outpacing the modest gains in output and prices. To our mode of thinking, this rare unanimity spells trouble for the bulls.

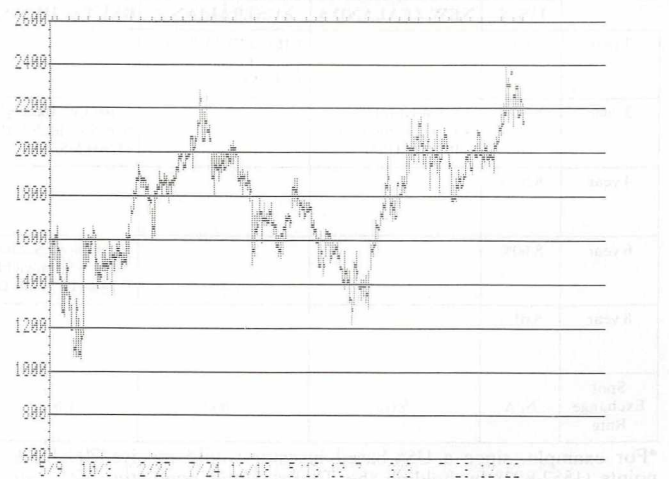
Technically, there are three signs of weakness: a) the backwardation has narrowed dramatically, usually a sign

that supplies have become plentiful; b) the "crack" has narrowed too, indicating less demand for products; and c) option premiums have fallen to recent historical lows (implied volatilities of 21% to 22%), indicating a high degree of complacency (the lull before the storm).

We believe prices are headed lower in a hurry. Our initial target is \$18/barrel, eventually testing the 1988 lows of \$12-\$13/barrel.

**STRATEGY:** Buy June '90 and July '90 put options, \$21/barrel striking.

Chart 16  
NYME Crude Light



**FRIEDBERG CAPITAL MARKETS**

# Switching to Sterling

The international upward movement in interest rates is pushing up US rates. This represents the external forces acting on US rates. The internal forces are slightly more complex. In order to patch the banks/savings and loan quagmire, the financing is moving more and more to the Treasury markets, which in turn leads to higher rates.

The other factor that indicates tighter interest rate policy comes from the Federal Reserve Bank's chairman, Alan Greenspan, who recently was quoted as saying that he was "concerned with inflation."

Therefore, on Friday, February 16, we recommended, via our Hotline Update, liquidating our US dollar denominated zero coupon Denmark bonds, which would suffer all the more in an environment of rising rates. An accompanying recommendation was made simultaneously to purchase British pound denominated bonds. The British pound is now on our buy list.

We make a market in the following British pound denominated bond: **Kingdom of Sweden** 9<sup>3</sup>/<sub>8</sub>% 14/4/93, presently priced to yield 13.43%, rated AAA by Moody's.

## Pacific Scientific update

February 12, 1990 — Pacific Scientific Company reported net earnings of \$4,367,000, equal to 74 cents a share, on sales of \$169,599,000 in the fiscal year ended December 29, 1989. In the previous year, the company showed a loss of \$4,093,000, or 74 cents per share on sales of \$180,886,000.

The Pacific Scientific bond is currently trading at 72½, to yield 12.28%.

### Recommended bond portfolio allocation

New Zealand dollar bonds	5%
US dollar high-yield convertible bonds	20%
Argentina Bonex	5%
US dollar floating-rate notes	35%
British pound fixed-rate bonds	17½%
Danish krone fixed-rate bonds	17½%

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 17**  
**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. **February 22, 1990.**

	U.S. \$	NEW ZEALAND \$	AUSTRALIAN \$	DEUTSCHEMARK	SWISS FRANC	JAPANESE YEN	DANISH KRONE	BRITISH POUND
2 year	8.49%		CIBC 13% 13/3/91, yields 15.20% (.680 A\$/US)				Stockholm 10% 10/11/91, yields 12.44% (6.919 US/DK)	
3 year	8.52%	Tourist Hotel 0% 4/6/93, yields 15.52% (.490 NZ/US*)		Euro Inv. Bk. 5½% 9/8/93, yields 9.18% (1.704 US/DM)		Canada 5% 23/7/93, yields 6.63% (138.03 US/JY)		Sweden 9% 14/4/93, yields 13.42% (1.499 BP/US)
4 year	8.56%							
6 year	8.60%			Bk of Nova Scotia 5% 7/5/96, yields 9.24% (1.734 US/DM)				
8 year	8.61%				Australia 5% 30/10/98, yields 7.14% (1.324 US/SF)			
Spot Exchange Rate	N/A	.5913	.7667	1.6735	1.476	145.5	6.441	1.7123

\*For example, since a US\$-based investor would receive 700 basis points (1552-852) by holding the Tourist Hotel bond, the NZ\$ can depreciate to .490 NZ/US from the present spot exchange rate of

.5913 NZ/US over the next 3 years 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 18  
Foreign Currency Bonds**

Date: February 22, 1990  
We offer the following bonds subject to change without prior notice:  
Min. a/c US\$5000.

PAY ISSUER/MTY./DATE/COUPON	<u>BID</u>	<u>OFFER</u>	<u>CURRENT ANN. YIELD TO MTY.</u>	<u>LAST PAY DATE</u>	<u>NEXT PAY DATE</u>
<b>CANADIAN DOLLAR DENOMINATED BONDS</b>					
GOVERNMENT OF CANADA (semi annual) 10 1/2% 5/12/90	98.25	- 98.55	12.62%	05/12/89	05/06/90
<b>NEW ZEALAND DOLLAR DENOMINATED BONDS</b>					
TORONTO DOMINION BANK 02/04/90 10% RISP eligible	99 7/8	- 100 3/8	Money market	02/04/89	02/04/90
<b>AUSTRALIAN DOLLAR DENOMINATED BONDS</b>					
TOURIST HOTEL (N.Z.) 04/06/93 zero coupon	61 3/4	- 62 1/2	15.52%	matures	04/06/93
COMMONWEALTH BANK OF AUSTRALIA 01/07/94 14%	98 1/4	- 99	14.26%	01/07/89	01/07/90
WORLD BANK 15/03/93 12 3/4% RISP eligible	98 1/4	- 99	13.16%	15/03/89	15/03/90
CAN. IMP. BANK OF COMMERCE 13/03/91 13% RISP eligible	96 1/2	- 98	15.20%	13/03/89	13/03/90
<b>DANISH KRONER DENOMINATED BONDS</b>					
STOCKHOLM 10/11/91 10 5/8%	96 1/2	- 97 1/4	12.44%	10/11/89	10/11/90
<b>BRITISH POUND DENOMINATED BONDS</b>					
RGM of SWEDEN 14/4/93 9 3/8%	89 3/8	- 90 1/8	13.42%	14/04/89	14/04/90
<b>DEUTSCHE MARK DENOMINATED BONDS</b>					
QUEBEC HYDRO 5 1/2% 1/5/96 RISP eligible	82 1/2	-	-	01/05/89	01/05/90
European INV. BANK 5 1/2% 9/8/93	88 3/4	- 89 1/2	9.18%	09/08/89	09/08/90
Bank of NOVA SCOTIA 5 5/8% 7/5/96 RISP eligible	82 3/4	- 83 1/2	9.24%	07/05/89	07/05/90
<b>SWISS FRANC DENOMINATED BONDS</b>					
GOVT. OF AUSTRALIA 30/10/98 5%	85 1/2	- 86 1/2	7.14%	30/10/89	30/10/90
<b>JAPANESE YEN DENOMINATED BONDS</b>					
GOVT. OF CANADA 23/1/93 5 5/8% RISP eligible	96 1/4	- 97	6.63%	23/07/89	23/07/90
<b>U.S. DOLLAR DENOMINATED FIXED CONVERTIBLE BONDS</b>					
PACIFIC SCIENTIFIC 7 3/4% 15/06/03(semi) 67 1/2-	72	- 72 1/2	12.28	15/12/89	15/06/90
CV @ \$38 p/sh	72	- 77	12.74%	26/06/89	26/06/90
SUNRISE MEDICAL INC. 7.25% 26/6/96 CV @ \$17 5/8 p/sh	49 1/2-	51 1/2	15.23%	15/05/89	15/11/90
ALDIANT COMPUTER 7.25% 15/05/12(semi) CV @ \$39.75 p/sh	65 1/2-	67 1/2	17.23%	01/09/89	01/03/90
COOPER CO'S. 10 5/8% 01/03/05(semi) CV @ \$27.45 p/sh call in 1995 \$100	37 1/2-	40 1/2	15.13%	10/06/89	10/06/90
DICOR ELECTRONICS 5.5% 1/3/12 (semi) CV @ \$39.50 p/sh	45.60	- 46.35	9.55%	matures	06/08/98
<b>U.S. DOLLAR DENOMINATED ZERO COUPON BONDS</b>					
KINGDOM OF DENMARK 6/11/98	45.60	- 46.35	9.55%	matures	06/08/98
<b>U.S. DOLLAR DENOMINATED FIXED RATE BONDS</b>					
ALBERTA 7 3/8% 9/12/91 RISP eligible	97 1/2	- 98 1/4	8.45%	09/12/89	09/12/90
SOUTHMARK CORP. 10 7/8% 1/11/89 (semi)	-	-	-	N/A	N/A
<b>U.S. DOLLAR DENOMINATED FLOATING RATE NOTES</b>	<u>BID</u>	<u>OFFER</u>	<u>CUR. COUPON</u>		
UNITED KINGDOM 24/9/96 3 mo. LIBID-1/8 (qly)	99.80	- 100	8 1/4%	28/12/89	28/03/90
REPUBLIC OF ITALY 30/4/93 3 mo. Libor(qly)	99.43	- 99.83	8 5/16%	31/01/90	30/04/90
REPUBLIC OF PORTUGAL 8/12/93 6 mo LIBOR +5 B.P. (semi)	99.80	- 100	8.2375%	08/12/89	08/06/90
BANCO CENTRAL DE CHILE 20/1/94 12 mo LIBOR+ 13/16 (annual)	62 3/4	-	-	22/01/90	22/01/90
** current yield	64.85	- 66.35	**10 11/16%	15/08/89	15/02/90
ARGENTINA BONEX series 82 6 MO LIBOR (semi)			*** 46.95%		
*** IRR					
Amortized 1/12 principal/year					

For further information and current prices please call:  
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**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: 1.6785)</u>
Australian dollar	0.7657-0.7667	0.7519-0.7531	0.7197-0.7214	Neutral	Neutral
Belgian franc	34.91-34.93	35.03-35.15	35.41-35.93	Remain long	Neutral
Danish krone	6.4500-6.4550	6.5105-6.5205	6.6890-6.7050	Remain long	Remain long
Dutch guilder	1.8876-1.8883	1.8905-1.8915	1.9001-1.9018	Remain long	Neutral
Greek drachma	158.20-158.40	160.90-165.30	172.20-187.90	Remain short	Remain short
Hong Kong dollar	7.8070-7.8080	7.8110-7.8130	7.8160-7.8240	Neutral	Neutral
Irish punt	1.5820-1.5835	1.5680-1.5715	1.5300-1.5385	Remain long	Neutral
Italian lira	1239.50-1240.00	1252.50-1256.00	1291.50-1297.00	Remain long	Remain long
Kuwaiti dinar	0.29020-0.29100	0.28985-0.29075	0.28965-0.29060	Neutral	Neutral
Malaysian ringgit	2.7035-2.7045	2.6910-2.6940	2.6635-2.6745	Neutral	Neutral
New Zealand dollar	0.5905-0.5915	0.5828-0.5841	0.5625-0.5645	Remain long	Neutral
Norwegian krone	6.4650-6.4700	6.5140-6.5230	6.6330-6.6500	Remain long	Neutral
Portugese escudo	147.20-147.40	150.20-150.85	159.20-163.40	Neutral	Neutral
Saudi Arabian riyal	3.7500-3.7510	3.7465-3.7490	3.7415-3.7455	Remain short	Remain short
Singapore dollar	1.8635-1.8645	1.8592-1.8612	1.8405-1.8495	Neutral	Neutral
Spanish peseta	108.13-108.23	109.79-109.97	114.73-115.08	Remain long	Neutral
Swedish krona	6.0740-6.0840	6.1750-6.1905	6.4495-6.4585	Remain long	Neutral

**Explanatory Notes**

\*Indicates change in recommendation from last 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
Buy	Sell
Sell	Sell
Sell	Buy

Cover

Liquidate

**HOTLINE UPDATE**

**Tuesday, January 30:**

No new recommendations. Market letter is in the mail.

**Flash Update, Friday, February 2, 9:35 a.m.:**

Two new recommendations:

- 1) Buy May sugar at market, risking 1420, close only.
  - 2) Buy June BP at market, placing stops at 158.00, close only.
- Also the market letter was mailed on Tuesday. Barring further changes, this flash update will replace our regular Friday wrapup.

**Tuesday, February 6:**

No changes or new recommendations.

**Flash update, February 9:**

One new recommendation: Sell April Comex gold at market, placing initial stops at 433.00, close only.

**Friday, February 9:**

The day of reckoning for gold bulls is at hand. We believe that the market is heading substantially lower over the short and medium term. As recommended this morning, you are short April Comex gold with initial stops at 433.00, close only.

**Tuesday, February 13:**

No changes or new recommendations.

**Flash update, February 16, 12:10 a.m.:**

A new recommendation. We are suggesting a change in our bond portfolio allocation. Liquidate the US zero coupon bond portion, which represents 15% of the total portfolio, and replace with a short-to-medium-term fixed-rate Sterling denominated bond. Specifically, we recommend the Kingdom of Sweden 14/4/93 trading presently to yield approximately 13.29.

2) Sell June long term Japanese yen government bonds trading on the LIFFE at market. Place initial stops at 96.75, close only. Please note the bonds' face value is 100 million Japanese yen, the equivalent of approximately 7½ US T-bond contracts.

3) One reminder: as of last Friday's flash, we are short April Comex gold with stops at 433.00, close only.

**Tuesday, February 20:**

Repeat as per our flash update, February 16.

**Friday, February 23:**

Our new recommendation: Liquidate long May sugar at market. Now a review of new positions suggested since the last letter.

1. You are long June BP as per our flash update of February 20, a.m. at approximately 164.30, with stops at 158.00, close only.

2. You are short April Comex gold as per our flash update of February 9 a.m. at approximately 423.00, with stops at 433.00, close only.

3. You are short June long term Japanese yen government bonds trading on the LIFFE as per our flash update on Friday, February 16, at approximately 94.90, with stops at 96.75, close only.

4. One change was recommended on February 16 in bond portfolio allocation. We liquidated the US zero-coupon bond portion, which represented 15% of the total portfolio, and replaced it with a short-to-medium-term fixed-rate Sterling-denominated bond. Specifically we recommended the Kingdom of Sweden 14/4/93 trading to yield 13.29.

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