# FRIEDBERG'S
## COMMODITY & CURRENCY COMMENTS

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# The return of monetarism
## and some thoughts about inflation and deflation

Monetarism. A central bank concern with the growth of monetary aggregates and its impact on prices. A response that leads to a policy of announcing target ranges for various monetary aggregates in the hope of producing price stability. It was in vogue in the '70s, when it became clear that excessive money growth had led to a dramatic bout of inflation. It lost advocates in the early to mid-'80s, when excessive money growth corresponded with a falling rate of inflation. It fell further into disrepute when a particularly important aggregate, M1, began to act erratically, a result of financial deregulation, leaving the shipmaster without a compass.

By 1986, the year of the collapse of oil prices and the year of nil inflation in the main G-7 countries, monetarism was paid only lip service to by the world's main central banks. In the "new era" of the '80s, money did not really matter. And so, it was possible for central banks to announce target ranges and blithely ignore them, exceeding them sometimes by as much as 50%.

Unbeknown to the monetary authorities, the common-sense link between money and prices had never been severed. The effect had either been postponed (thanks to something called falling velocity) and/or the true, trusty monetary aggregate had temporarily slipped from sight (M2, in the US) and confounded the experts.

This essay is not intended to be a survey of world monetarism, its practice and effects. By concentrating solely on the US, we trust the point will be made.

Recent academic studies have revindicated M2 as a reliable guide to monetarism and as a reliable forecaster of price inflation. (We will be drawing primarily from "M2 and Monetary Policy" by Robart L. Hetzel, which appeared in the Federal Reserve Bank of Richmond's Economic Review, September/October 1989.) Noting the "old" Friedmanite proposal that M2 be made to grow at 3% per year, it reviews the quantity equation whose formula implies that the trend rate of growth of money will equal the trend rate of growth of real income plus the trend rate of growth of prices and concludes:

> "This...formula was used to predict the change in the price level since 1950. The price level (consumption expenditures deflator) and M2 were expressed as index numbers with a base of 100 in 1950. The figure for the percentage excess of M2 over a trend line rising at three percent per year was used as the prediction of the percentage change in the price level from its 1950 base. The value of the index number for the price level in 1988 was predicted to be 517, while its actual value was 475. The actual value of the price level then was 8.5 percent below the predicted value. It follows that if procedures had been in place since 1950 to constrain M2 to grow around a trend line rising at three percent per year, the price level in 1988 would have fallen from 100 in 1950 to 91.5, a decline of 8.5 percent. Instead, the price level rose to 475. An operationally significant trend-line target for M2 will eliminate most of the drift over time in the price level."

Chart 1 shows that the ratio of GNP to M2, known as M2 income velocity, is virtually the same today as it was in the early 1960s despite a great deal of deregulation. The fluctuation in M2 velocity over the period can be explained largely by the sensitivity of M2 to interest rates and inflation, i.e.,

### In this issue




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

M2 velocity moves in the same direction as interest rates and inflation.

The sharp drop in inflation and interest rates (primarily a commodity inventory effect) in the 1980-1986 period caused velocity to collapse as well (from 1.80-1.54) offsetting rapid M2 growth and emitting a misleading signal of the true inflationary pressures.

The keener observers believed they had entered a virtuous circle: Falling inflation and interest rates caused velocity to fall, which in turn offset 9.4% rates of growth of M2. The less keen ones believed that monetarism, in an age of technology and commodity surpluses, was dead.

In fact, worldwide inflation has reared its ugly head over the past three years. It appears to be accelerating slowly despite heroic tightening attempts by practically every Central Bank in the OECD: from a 1986 low of 2.7% per annum to a 1990 forecast of 6.4%. Velocity has snapped back to its mean value (1.64 in our Chart 1). And there's the probability that as we have seen, rising inflation *per se* and rising rates will swing velocity at least temporarily higher. This will complicate matters a great deal in the coming months.

In the US it *appears* that since 1987, with the advent of Greenspan to the Fed, Monetarism has come back to life. Wittingly or unwittingly, the Fed has managed to hold M2 growth below 5% per annum, well below the mid-point of its announced target ranges (7% for 1987, 6% for 1986, and 5% for 1989). Were it not for rising velocity, inflation would be bordering 2% per annum. Disquietingly, over the past 12 months, M2 has been allowed to grow at 5.9% per annum and over the past two months, at an annualized 7% per annum. It therefore appears that there has been a distinct easing in policy primarily because of the Fed's refusal to raise Fed funds in the face of rising bond yields (see also the next article on the yield stress index).

* * * * *

Taking note of the S&L banking collapse and the real estate depression, there are those who freely predict an outright deflation. They show their ignorance of monetary processes.

There can be no generalized price deflation without a corresponding money supply deflation (as occurred in 1929-1933, when money supply dropped by one third). What's more, there can be a private sector credit deflation (as we have been expecting) while overall money supply continues to increase. This is true because commercial banks will expand their assets via the purchases of Treasury obligations rather than via the granting of loans. In effect, they reliquify (see *FC&CC* Oct. '89 and March '90).

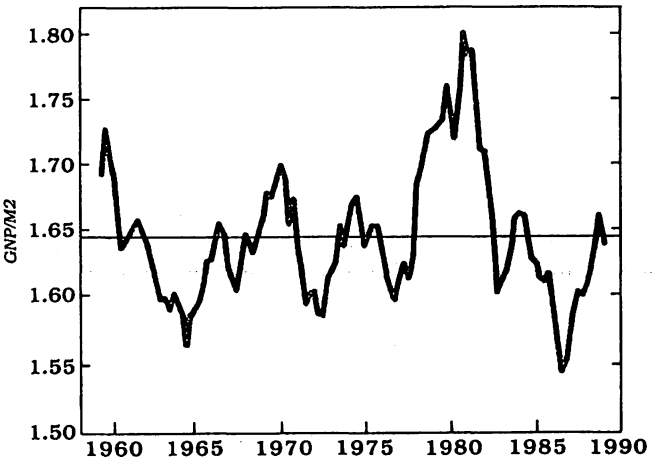
The credit contraction, if accompanied by money supply (as M2) increases will *affect only those sectors in the economy that most depend on credit,* i.e., real estate, highly leveraged businesses and stocks, and other durable goods such as cars. A real estate deflation, in the context of steady, non-inflationary money growth, is in fact a salutary development. Price flexibility is the hallmark of the properly functioning capitalistic system; resources move away from sectors with falling prices and profit margins and into sectors with rising prices and profit margins.

The early '90s will be characterized by goods (at the consumer and wholesale level) and services price inflation and asset deflation, resulting from tightening credit, what we referred to as banking reliquification in earlier issues, and rising interest rates. The mirror image of the '80s.

***STRATEGIC CONCLUSION:*** *The early '90s will see a much more hospitable climate than the '80s for commodity prices and a much less hospitable climate for financial assets and highly leveraged hard assets.*

**Chart 1**

*M2 VELOCITY*




## INTEREST RATES

# On the yield stress index

For more than a year, we have argued that the Fed, under the growing influence of Vice Chairman Johnson and Governor Angell, has adopted a Wicksellian approach to monetary policy (see the following issues of *FC&CC;* March 19, 1989; October 29, 1989; January 28, 1990; and March 25,1990). This approach to policy requires the Fed to embrace the objective of stable prices. To achieve this objective, the Wicksellian approach to monetary policy further requires the Fed to use market prices as guides in determining whether monetary policy is appropriate. Specifically, the following

Wicksellian targets are consistent with a stable price objective: a flat yield curve, stable commodity prices, and a stable foreign exchange value for the dollar.

To understand Wicksellian monetary policy, let's assume that the Fed is faced with the following market price trends: the yield curve is becoming steeper, commodity prices are rising, and the dollar's foreign exchange value is falling. With these price trends, a Wicksellian would conclude that monetary policy is too lax.

In consequence, a Wicksellian would recommend an increase in the Fed Funds rate (Wicksell's "bank rate"). This would cause the T-bond rate (Wicksell's "natural rate") to stabilize or fall. Hence, the yield curve would become flatter.

Moreover, commodity prices would stabilize or fall and the dollar's foreign exchange value would stabilize or rise. Of course alternative assumptions about trends in yield curves, commodity prices, and the dollar's exchange value would generate alternative Wicksellian monetary policy reactions.

## Policy confirmed

Even though Fed officials have confirmed that (since about 1987) monetary policy is being framed along Wicksellian lines, some have questioned whether there is empirical evidence to support this conclusion. A Wicksellian policy approach is confirmed because the spread between long and short rates has narrowed significantly. Recall that a narrow spread (flat yield curve) is required when a Wicksellian policy is followed.) For example, 10-year Treasury yields minus Fed Funds rates averaged +173 basis points in 1987, narrowed to +128 basis points in 1988, and became squeezed to -72 basis points in 1989.

In the first quarter of 1990, the spread averaged +17 basis points, and in recent weeks it has ranged between +35 and +50 basis points. Chart 2, which plots T-bond futures yields minus T-bill futures yields also confirms that the Fed has been following a Wicksellian flat yield curve policy.

* * * * *

Given that the Fed is following a Wicksellian approach to monetary policy, we must inquire whether it will achieve the Fed's stable price objective. To address this matter, we turn to Professor Wicksell's native Sweden. That nation abandoned the gold standard in 1931 and switched to a Wicksellian policy regime that lasted until 1939.

This is perhaps the longest and best documented Wicksellian experience on record. While the rest of the world went through a wrenching depression and accompanying deflation, Sweden put in a relatively good performance (see Chart 3).

This is remarkable, because Sweden was a small open economy that was heavily dependent on foreign trade. Hence, we would expect that its performance during the world depression of the 1930s would have been worse than that in most other nations.

By 1935, Sweden's real income and employment exceeded 1929 levels, and prices had stabilized. In comparison, real income, employment, and prices in the US fell much more than Sweden's during the depression.

Moreover, as late as 1937, these US indicators still remained below their 1929 levels. What is more impressive is the fact that under Wicksellian price stability, Sweden's long-term nominal interest rates, which were about equal to the USA's in 1929, ratcheted downward much more sharply than those in the US, even though deflation was much more severe in the US.

Hence, even though the depression was much more devastating in the US, its real interest rates became much higher, relative to Sweden's, during the period 1929-1937.

## *CONCLUSIONS AND IMPLICATIONS:*

- The Fed is Wicksellian.
- Wicksellian policies will stabilize prices.
- The yield curve has become steeper in recent weeks. This implies that we can anticipate a Fed tightening (an increase in short rates) to flatten the yield curve.

Indeed, we have developed a *Yield Stress Index* that is based on actual market data for 1989-1990. This index registers "stress" when short rates are above or below an "equilibrium" short rate. (Note that the "equilibrium" short rate is determined after observing current long-term market rates.) Hence, our index registers "stress" when there is a misalignment between long and short rates.

At present, short-term market rates are registering -26 basis point stress. Hence, to alleviate stress, short rates should rise by about 25 basis points, relative to long rates. In other words, the yield curve is currently too steep ("stressed") and should be flattened by about 25 basis points. In the *short run*, short rates will rise and the yield curve will become flatter.

- If this *short-run* pattern is obtained, the economy will continue to grow at a modest pace and inflation expectations will eventually be squeezed from the economy. In consequence, both short and long interest rates will eventually ratchet downward. Hence, as a result of a *short-run* increase in short rates, all rates will fall in the *long run*.

**– Dr. Steve H. Hanke**

***STRATEGY:*** *Buy December '90 Eurodollar puts, 91.50 striking.*

**Chart 2**

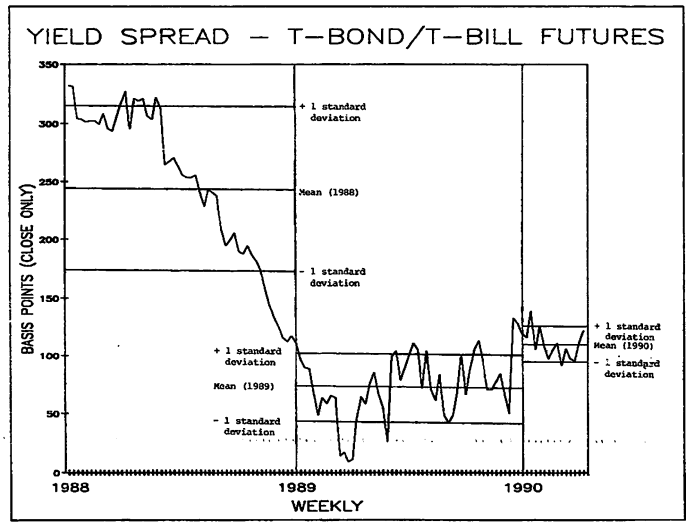



**Chart 3**
**USA vs. Sweden (Wicksellian)**

| Indexes | 1929 | 1931 | 1933 | 1935 | 1937 |
|---|---|---|---|---|---|
| Real Income | | | | | |
| U.S.A. | 100 | 82 | 67 | 80 | 98 |
| Sweden | 100 | 94 | 92 | 106 | 122 |
| Employment | | | | | |
| U.S.A. | 100 | 89 | 81 | 89 | 97 |
| Sweden | 100 | 99 | 95 | 102 | 106 |
| Inflation-Deflation (Consumer Price Index) | | | | | |
| U.S.A. | 100 | 89 | 75 | 80 | 84 |
| Sweden | 100 | 94 | 92 | 93 | 97 |
| Long (1-year Corporate AAA) Interest Rates | | | | | |
| U.S.A. | 4.7 | | 4.5 | | 4.0 |
| Sweden | 4.8 | | 2.8 | | 2.3 |

## *STOCK MARKET INDEXES*

# The bear: much more to come

The continued and alarming deterioration in banks' financial condition as well as disappointing earnings in a number of key cyclical and basic industry issues were the catalyst for a new wave of selling that sent the broad S&P 500 index down 2.68% this past week.

The pounding came just at a time when sentiment had become most complacent: *Investors Intelligence* reported last week more bulls (44.6%) than bears (42.7%), the most bullish vibes in many moons. Irony of ironies, last week Japan put on its best performance since the top, with the one-day advance of 750 points accompanied by a rising chorus of participants: 1 billion shares, up from an average of 450-500 million shares on the way down. As the old saying goes: The market will fool most of the people, most of the time...

As we pointed out last month, the market cannot withstand the twin combination of rising interest rates and falling corporate profits. Risk perceptions are increasing: Secondary stocks continue to underperform the big capitalization stocks, a behavior predicted by our discount model (see *FC&CC* Dec. '89 and see Chart 5).

The bear market has much further to go.

***STRATEGY:*** *We remain comfortably short June '90 Value Line, which is making new six-month lows (see Chart 4), and which we first recommended in our Dec. '89 issue. Also, retain long June and September 1990 S&P puts.*

**Chart 4**
**KBT Value Line Jun 90**

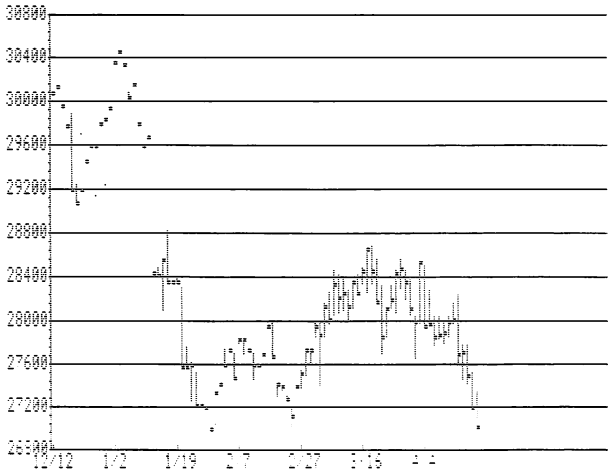
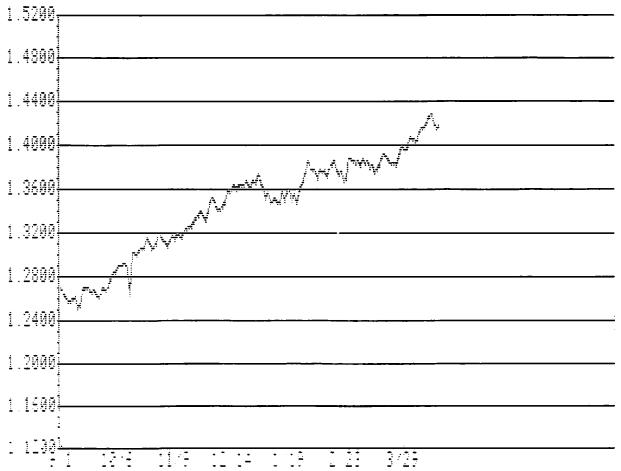



**Chart 5**
**S&P/Value Line**



## CURRENCIES

# Greenback under pressure

Despite a significant improvement in the monthly trade balance (see Chart 6), the US dollar necessitated a strong dosage of G-7 intervention to avoid falling to new multi-year lows *vis à vis* the EMS bloc of currencies (see Chart 7).

Interest rate differentials *vis à vis* the European Monetary System as reflected in the three-month ECU less three-month Eurodollar (Chart 8) and ECU less US 10-year government bond (Chart 9) continue favorable to the European bloc. Also, real economic growth in Western Europe exceeds by a fair margin US economic growth, further aiding capital flows in an easterly direction across the Atlantic.

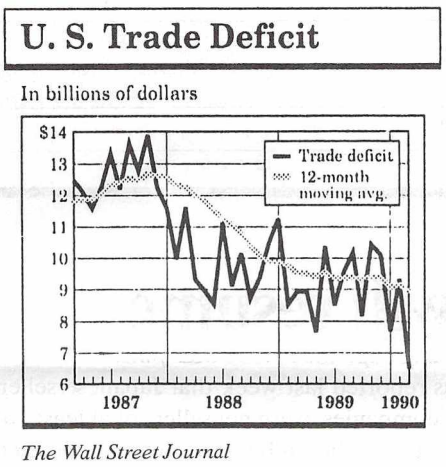
A new factor may begin to come into the equation, to wit, the US banking situation is deteriorating so rapidly and so dramatically that it would not be difficult to imagine a capital flight based on fright. (To counter the confidence shock, the Fed may be forced to raise interest rates, which would further aggravate some of the banking problems).

Our sense is that the US dollar is under pressure, threatening to break to new lows, *vis à vis* the EMS. On the other hand, the dollar remains cheap *vis à vis* the Japanese yen. (See the following article on Japan.)

***STRATEGY:*** *Heretofore, we satisfied ourselves with avoiding a US dollar exposure, preferring to trade the various, exciting crosses. As a result, we have been long Swiss francs (and other European currencies) versus short yen. We continue to like the cross trade and advise staying put. However, at this time we would suggest a conservative outright long position in the stronger European currencies* vis à vis *the US dollar. To this end we recommend you buy a) June'90 British pound, risking 159.00 close only, and b) June '90 Swiss francs, risking 65.40 close.*

*In addition we note that implied option volatilities for the Swissie are historically low; therefore, we advise the purchase of out-of-the-money calls.*

**Chart 6**




*The Wall Street Journal*

**Chart 7**
**CME Deutsche Mark**

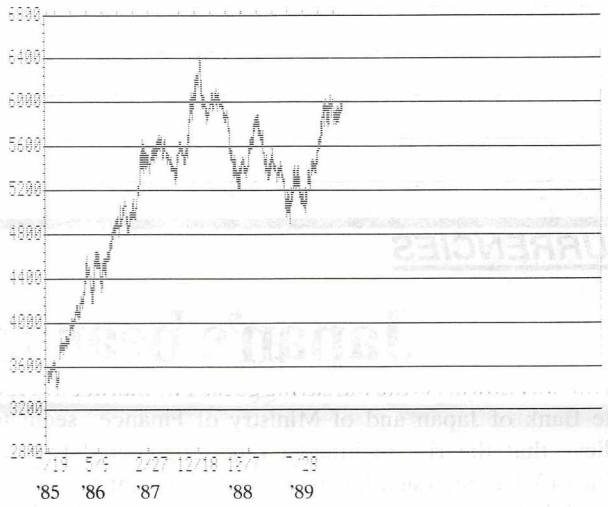
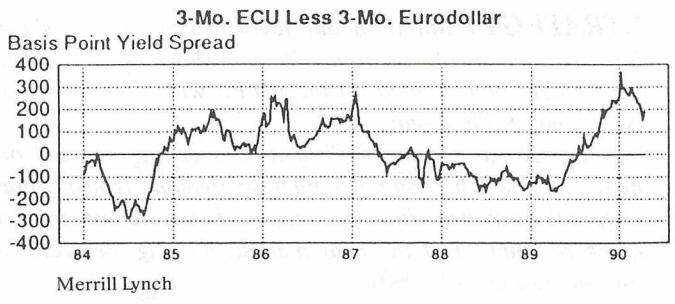
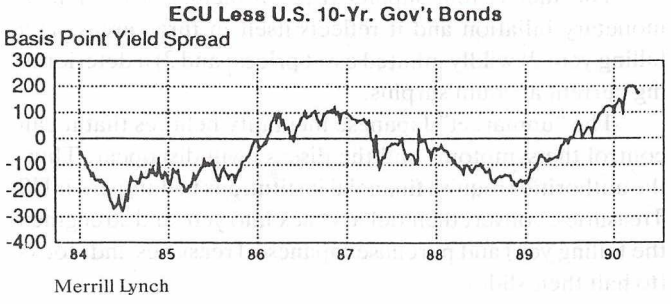



**Chart 8**




Merrill Lynch

**Chart 9**




Merrill Lynch

**Chart 10**
**DM/SF**


**Chart 11**
**CME Swiss Franc Jun 90**

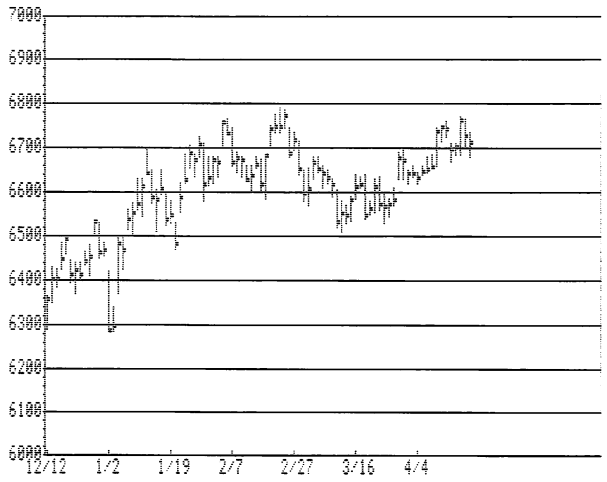
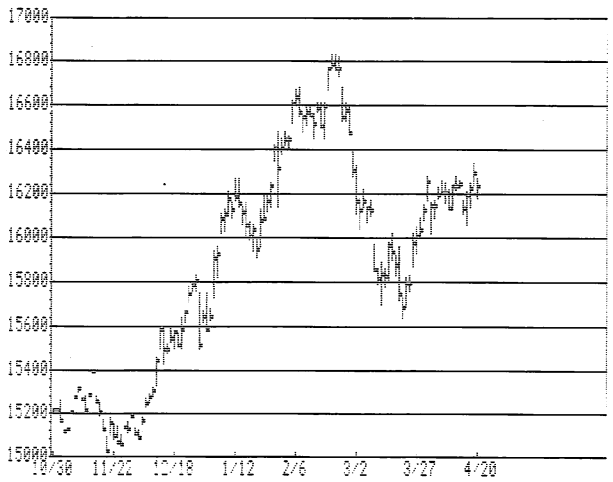



**Chart 12**
**CME British Pound Jun 90**




## CURRENCIES

# Japan's bear market will resume

The Bank of Japan and of Ministry of Finance seem to believe that the rise in interest rates engineered to date (Chart 13) has been significant enough to warrant a period of consolidation and observation. At the same time, they have been more aggressive regarding foreign exchange intervention in the hope of quelling what they believe is the source of instability: the falling yen.

The fact is that Japan's true problem is one of high monetary inflation and it reflects itself in three areas: 1) a falling yen; 2) wildly inflated asset prices; and 3) a deteriorating current account surplus.

The "unmarket" Japanese mentality believes that it can control the symptoms and the disease will disappear. Thus, the authorities require financial institutions to dump their US Treasuries, convert their dollars back into yen (and strengthen the falling yen) and purchase Japanese Treasuries and stocks (to halt their slide).

It was reported last week that Japanese sellers, mostly insurance companies, were net sellers of at least $6 billion of Treasury notes and bonds between the start of their fiscal year on April 1 and April 13. Silly. In the end, as we have been saying for many months, interest rates will have to rise sufficiently to check the expansion of money and credit. No amount of manipulation will obviate the need to bite the bullet.

***STRATEGY:*** *Maintain our favorite cross trade: short Japanese yen/long Swiss francs. Remain short the 10-year 6% government bond traded on the LIFFE with stops at 96.75, basis June '90, close only.*

*The Nikkei "broke out" of its descending channel on heavy volume. This countertrend false breakout typically precedes major moves with the trend. We therefore anticipate a quick resumption of the bear market, looking for eventual lows in the 15,000-16,000 area.*

**Chart 13**
**LIF Japanese Bond Jun 90**

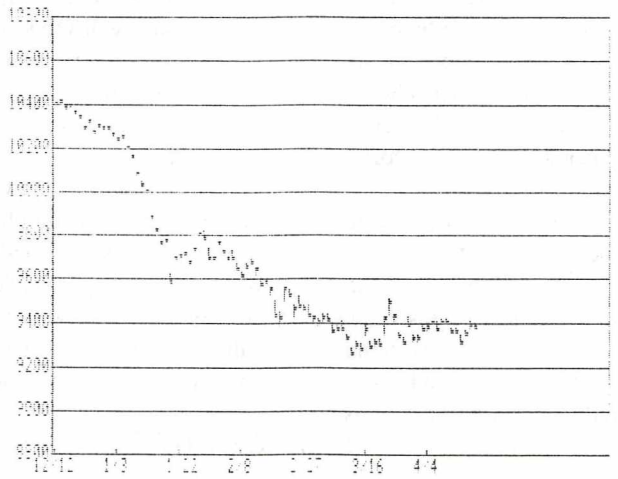


**Chart 14**
**CME Japanese Yen Jun 90**

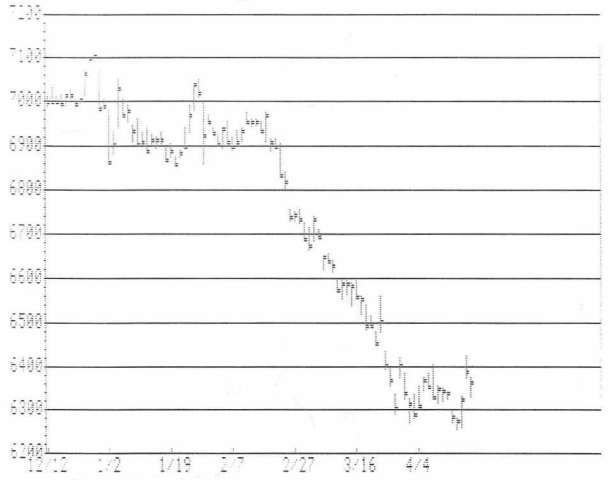
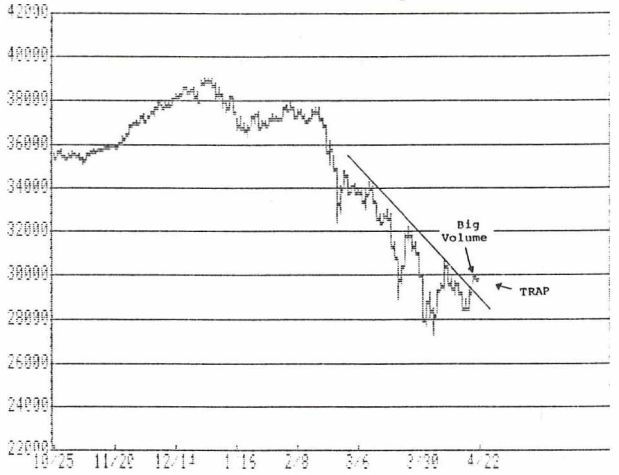


**Chart 15**
**NIKKEI 225 Index Spot**




## GOLD

# Standing aside

***STRATEGY:*** In our Hotline Update of April 2, we advised covering short positions first initiated on February 9, accepting handsome profits. Stand aside.

## CRUDE OIL

# The trend is down

Pushing their luck too far, the Opec producers managed to break the camel's back. Will they be able to put Humpty-Dumpty together again? The consensus of the oil experts (those who did not believe that oil prices would not significantly deviate from $18.50 to $19.00 during 1990) is a resounding yes. All that Opec has to do is to rein in production to just under the agreed ceiling of 22 million barrels per day (b/d) from the present, eight-year high of 24 million b/d.

But who *really* knows what is the demand for Opec oil? Recent statistics indicate that US demand for the first three months of this year is off 2.6%. Moreover, OECD demand is expected to rise by less than 1% during 1990, the smallest

increase since 1986. And, unlike last year, there have been few, if any, significant accidents playing in favor of Opec.

Finally, demand equations fail to take into account inventory movements. If, as an example, Opec overproduced (as is likely) 2.5 million b/d for five months, then the "overhang" is 375 million barrels. Falling prices and rising worldwide interest rates make it unattractive to hold this stock. Therefore, Opec will have to *absorb* the overhang by cutting output 2.5 million b/d below their perceived underlying demand for as much as five months, or by five million b/d for 2.5 months, or by any combination thereof. The cutback commitment must be *credible* or else the total inventory overhang will be dumped and drive prices to 1986 lows, or even lower.

There are then four elements in the equation: 1) What is the true underlying demand for Opec oil: 22 million b/d, 21 million b/d or a much lower figure (the lower the figure of course, the more bearish the picture)? 2) How will Opec deal with the presumed overhang (375 million barrels, our guess)? 3) How well will Opec nations agree to sharing in the cutbacks (will the non-Gulf nations "forgive" the UAE, Kuwait, and Saudi overproduction in the next pow-pow, May 2 and May 25)? And 4) How credible will their cutback commitment be?

In the interim, new supplies of oil (last year the world found 5.5 times as much oil as it consumed) and natural gas continue to make inroads. The exceptional years 1987-1988, years of very rapid worldwide growth and marred by major accidents, are unlikely to be repeated. Opec, in or opinion, still faces a resumption of the trend prevalent in the late '70s and most of the '80s — declining total revenues.

***STRATEGY:*** *Having attained our first target, $18/barrel WTI crude, we now set our sights in the low teens. Remain short via put options.*

**Chart 16**
**NYME Crude Light Jun 90**

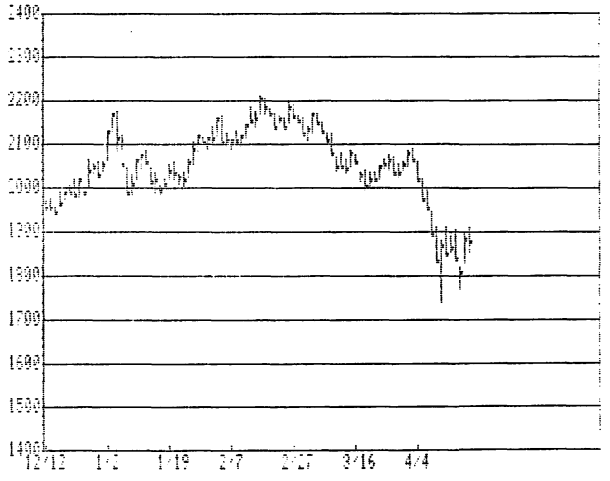
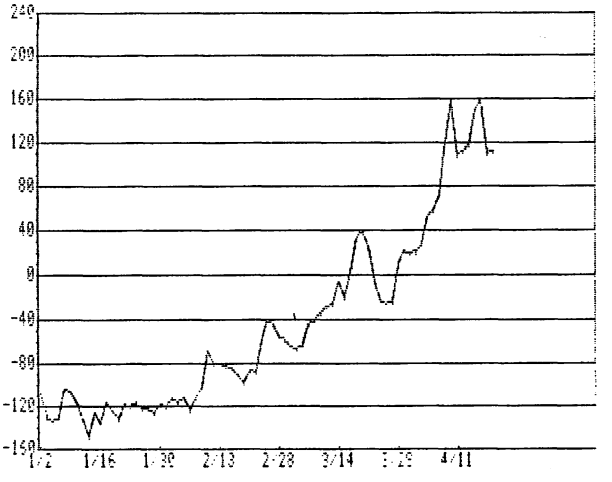



**Chart 17**
**Dec-Jun Crude Oil**




## FRIEDBERG CAPITAL MARKETS

**Recommended bond portfolio allocation**

| | |
|---|---|
| Swiss franc denominated bonds | 10%* |
| US dollar high-yield convertible bonds | 20% |
| Argentina Bonex | 10% |
| US dollar floating-rate notes | 25%** |
| British pound fixed-rate bonds | 17.5% |
| Danish krone fixed-rate bonds | 17.5% |

*New position

**Decreased from 30%

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## Chart 18
## 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. **Rates as of April 19, 1990.**

| | U.S. $ | NEW ZEALAND $ | AUSTRALIAN $ | DEUTSCHEMARK | SWISS FRANC | JAPANESE YEN | DANISH KRONE | BRITISH POUND |
|---|---|---|---|---|---|---|---|---|
| 2 year | 8.80% | | CIBC 14% 27/7/92, yields 13.23% (.5369 NZ/US) | CIBC 13% 13/3/91, yields 14.06% (.7038 A$/US) | | | Stockholm 10⅝%, 10/11/91, yields 10.71% (6.600 US/Dkr.) | |
| 3 year | 8.85% | Tourist Hotel 0% 4/6/93, yields 16.23% (.4776 NZ/US) | World Bank 12¾% 15/3/93, yields 13.6% (.6802 A$/US) | Euro Inv. Bk. 5½% 9/8/93, yields 8.87% (1.6818 US/DM) | | Canada 5⅝% 23/7/93, yields 7.08% (149.36 US/JY) | | Sweden 9⅜% 14/4/93, yields 14.34% (1.417 BP/US) |
| 4 year | 8.85% | | CBA 14% 1/7/94, yields 15.88% (.6457 A$/US) | | | | | |
| 6 year | 8.85% | | | Bk. of Nova Scotia 5⅝% 7/5/96, yields 9.04% (1.698 US/DM) | | | | |
| 8 year | 8.88% | | | | Australia 5% 30/10/98, yields 7.17% (1.309 US/SF) | | | |
| Spot Exchange Rate | N/A | .5815 | .7736 | 1.681 | 1.486 | 156.9 | 6.374 | 1.6425 |

*For example, since a US$-based investor would receive 443 basis points (1323-880) by holding the CIBC NZ$ bond, the NZ$ can depreciate to .5369 NZ/US from the present spot exchange rate of .5815 NZ/US over the next 2 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 19
## Foreign Currency Bonds

Date: April 19, 1990
We offer the following Bonds subject to change without prior notice: Minimum amount US$5,000
(Cdn.$7,000)

| PAY ISSUER/MTY.DATE/COUPON | BID | OFFER | CURRENT ANN. YIELD TO MTY | LAST PAY NEXT PAY DATE |
|---|---|---|---|---|
| **CANADIAN DOLLAR DENOMINATED BONDS** | | | | |
| GOVERNMENT OF CANADA (semi annual) 05/12/90 10 1/4% | 98 - | 98.30 | 13.04% | 05/12/90-05/06/90 |
| **NEW ZEALAND DOLLAR DENOMINATED BONDS** | | | | |
| CAN.IMP.BANK OF COMMERCE 27/07/92 14% RRSP eligible | 100 1/2- | 101 1.4 | 13.23% | 27/07/89-27/07/90 |
| TOURIST HOTEL (N.Z.) 04/06/93 zero coupon | 60 - | 62 3/4 | 16.23% | matures -04/06/93 |
| **AUSTRALIAN DOLLAR DENOMINATED BONDS** | | | | |
| COMMONWEALTH BANK OF AUSTRALIA 01/07/94 14% | 99 3/8- | 100 1/8 | 13.88% | 01/07/89-01/07/90 |
| WORLD BANK 15/03/93 12 3/4% RRSP eligible | 97 1/4- | 98 | 13.60% | 15/03/90-15/03/91 |
| CAN.IMP.BANK OF COMMERCE 13/03/91 13% RRSP eligible | 98 - | 99 | 14.06% | 13/03/90-13/03/91 |
| **DANISH KRONE DENOMINATED BONDS** | | | | |
| STOCKHOLM 10/11/91 10 5/8% | 99 - | 99 3/4 | 10.71% | 10/11/89-10/11/90 |
| **BRITISH POUND DENOMINATED BONDS** | | | | |
| KGDM of SWEDEN 14/4/93 9 3/8% | 87 7/8- | 88 5/8 | 14.34% | 14/04/89-14/04/90 |
| **DEUTSCHE MARK DENOMINATED BONDS** | | | | |
| QUEBEC HYDRO 5 1/2% 1/5/96 RRSP eligible | 83 5/8- | 84 5/8 | 8.91% | 01/05/89-01/05/90 |
| EUROPEAN INV. BANK 5 1/2% 9/8/93 | 89.95 - | 90.70 | 8.87% | 09/08/89-09/08/90 |
| BANK OF NOVA SCOTIA 5 5/8% 07/05/96 RRSP eligible | 83 7/8- | 94 5/8 | 9.04% | 07/05/89-07/05/90 |
| **SWISS FRANC DENOMINATED BONDS** | | | | |
| GOVT.OF AUSTRALIA 30/10/98 5% | 85 1/2- | 86 1/2 | 7.17% | 30/10/89-30/10/90 |
| **JAPANESE YEN DENOMINATED BONDS** | | | | |
| GOVT.OF CANADA 23/7/93 5 5/8% RRSP eligible | 94 7/8- | 95 7/8 | 7.08% | 23/07/89-23/07/90 |

| PAY ISSUER/MTY.DATE/COUPON | BID | OFFER | CURRENT ANN. YIELD TO MTY | LAST PAY NEXT PAY DATE |
|---|---|---|---|---|
| **U.S.DOLLAR DENOMINATED FIXED CONVERTIBLE BONDS** | | | | |
| PACIFIC SCIENTIFIC 7 3/4% 15/06/03(semi) CV @$38 p/sh | 68 3/4- | 70 3/4 | 12.35% | 15/12/89-15/06/90 |
| SUNRISE MEDICAL INC.7.25% 26/6/96 CV @$17 5/8 p/sh | 71 - | 75 | 13.75% | 26/06/89-26/06/90 |
| ALLIANT COMPUTER 7.25% 15/05/12(semi) CV @$39.75 p/sh | 54 1/2- | 56 1/2 | 13.50% | 15/11/89-15/05/90 |
| COOPER CO'S. 10 5/8% 01/03/05(semi) CV @$27.45 p/sh call in 1995 @100 | 68 - | 70 | 16.00 | 01/08/90-01/09/91 |
| DICEON ELECTRONICS 5.5% 1/3/12 (semi) CV @$39.50 p/sh | 36 1/2- | 41 | 14.53% | 01/03/90-01/09/91 |
| **U.S.DOLLAR DENOMINATED ZERO COUPON BONDS** | | | | |
| KINGDOM OF DENMARK 6/8/98 | 45 - | 46 | 9.83% | matures -06/08/98 |
| **U.S.DOLLAR DENOMINATED FIXED RATE BONDS** | | | | |
| ALBERTA 7 3/8% 9/12/91 RRSP eligible | 96 5/8- | 97 5/8 | 8.96% | 09/12/89-09/12/90 |
| **U.S.DOLLAR DENOMINATED FLOATING RATE NOTES** | **BID** | **OFFER** | **CURR.COUPON** | |
| UNITED KINGDOM 24/9/96 3 mo.LIBID-1/8 (qtly) | 99.75 - | 100.05 | 8 1/4% | 28/03/90-28/06/90 |
| REPUBLIC OF ITALY 30/4/93 3 mo Limean(qtly) | 99.50 - | 99.90 | 8 5/16% | 31/01/90-30/04/90 |
| REPUBLIC OF PORTUGAL 8/12/93 6 mo LIBOR +5 B.P.(semi) | 99.90 - | 100.20 | 8.2375% | 08/12/89-08/06/90 |
| **LDC US$ DENOMINATED BONDS** | | | | |
| ARGENTINA BONEX series 82 6 MO LIBOR (semi) ammort. 1/12 of princ./year *IRR | 81.20 - | 83.55 | 8.4375% *24.96% | 15/02/90-15/08/90 |
| ARGENTINA BONEX series 80 6 MO LIBOR (semi) ammort. 1/12 princ./year ** IRR | 95.05 - | 96.70 | 8 5/16% **19.76% | 27/11/89-27/05/90 |

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

## THE EXOTICS

# New Zealand dollar

New Zealand's bout with restructuring is proving to be more difficult and lengthier than originally anticipated. Inflation expectations have become deeply imbedded in the 5% to 7½% range, a phenomenon that was not helped by the two-staged introduction of the 12½% goods and services tax. The last increase by 2½ percentage points in July 1989 racheted the CPI rate upwards to 7%, where it stayed until early this year. The first quarter of 1990 has produced a respectable CPI increase of 0.9% (slightly more than 4% annualized). The government is optimistic about reaching its goal of 0-2% inflation by December 1992, an agreement signed with the Reserve Bank and which forms part of the requirements of the Reserve Bank Act, which came into force on February 1.

Aside from the highly variable rate of growth of M1, the broad aggragates have shown pronounced moderation from 1985-1988 but have since then not shown an improvement (see Chart 20). If the Reserve Bank is to achieve its goal of price stability, it will have to rein in much more substantially the broader aggregates.

Interestingly, the still-sharp increase in M1 (18.7% January over January 1989) has been a better indicator of excessive domestic nominal demand. As a result, real GNP growth of 2½% to 2% has brought in its wake a sharp deterioration of the current account deficit: From a low of 1.6% of GNP at the end of 1988, it has now moved up to almost 5%.

Clearly, there is a need for more tightening. The need for austerity is further dictated by the sharp deterioration in the country's terms of trade: Prices for some goods, such as aluminum, wool, and wood pulp, have continued to drop, while import prices rose.

Aside from too rapid monetary credit expansion, two major areas of concern remain. Labor market reforms need to be far more drastic than heretofore. And the government needs to accelerate privatization efforts, which to date have raised NZ$2.6 billion but have seen the participation of the public sector disappointingly increase since 1985 (see Chart 21).

On a more positive note, free trade with Australia and a progressive cut in import tariffs on most other New Zealand imports which will decline to 10% by 1996, begin to take effect from July 1, 1990. This should bring a much needed whiff of competitiveness to the New Zealand economy.

The New Zealand dollar, though remarkably stable *vis à vis* the US, has fallen 5½% *vis à vis* the Australian dollar over the past two months, a natural reflection of the deteriorating current account cum monetary inflation situation. We look for a more determined central bank policy before we wish to commit further funds to the New Zealand money and capital markets and before we establish long positions in the Kiwi forward market.

**Chart 20**
**Money and credit aggregates**

Year-on-year percentage changes

| | End of month | M3 | Private-sector credit |
|---|---|---|---|
| 1985 | December | 25.5 | 33.7 |
| 1986 | December | 20.4 | 22.6 |
| 1987 | December | 16.0 | 17.2 |
| 1988 | December | 3.1 | 9.2 |
| 1989 | December | 4.6 | 10.4 |

*Source:* Reserve Bank of New Zealand, *Bulletin.*
*OECD Economic Surveys: New Zealand*

**Chart 21**

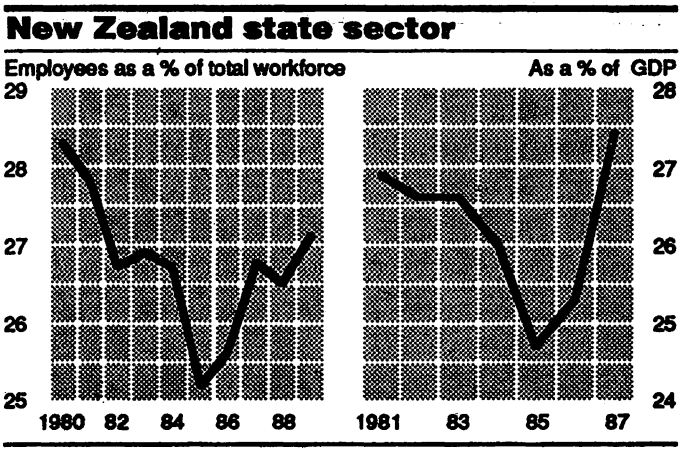

**Chart 22**

| YEAR | FOREIGN ASSETS (Min. US$) | CURRENT ACCOUNT As % of GNP % | CUMULATIVE 12 QTR. Current Account (Min. US$) |
|---|---|---|---|
| 1970 | 317 | -3.76 | -283 |
| 1971 | 547 | -0.25 | -228 |
| 1972 | 888 | +1.74 | - 88 |
| 1973 | 1139 | -0.97 | + 22 |
| 1974 | 568 | -12.82 | -1761 |
| 1975 | 55 | -8.46 | -3092 |
| 1976 | - 98 | -5.81 | -3772 |
| 1977 | -231 | -4.72 | -2664 |
| 1978 | -234 | -2.73 | -1980 |
| 1979 | 425 | -3.90 | -2002 |
| 1980 | 317 | -4.00 | -2236 |
| 1981 | 729 | -4.51 | -2866 |
| 1982 | 797 | -6.89 | -3654 |
| 1983 | 850 | -4.21 | -3696 |
| 1984 | 1849 | -6.61 | -4328 |
| 1985 | 1521 | -7.78 | -4127 |
| 1986 | 1371 | -6.42 | -4640 |
| 1987 | 2227 | -5.00 | -4650 |
| 1988 | 3014 (June) | -1.96 | -4000 |

**Chart 23**

| | | | | BASKET U.S. 25% UK 13% JAPAN 29% AUST 33% | |
|---|---|---|---|---|---|
| YEAR | NEW ZEALAND DOLLAR PER U.S. DOLLAR (PERIOD AVG.) | U.S. 1970 =1.00 | U.S. 1978 =1.00 | 1970 =1.00 | 1978 =1.00 |
| 1967 | 1.3554 | 0.8253 | 1.1096 | 0.8716 | 0.9670 |
| 1968 | 1.1170 | 1.0019 | 1.3470 | 1.0167 | 1.1279 |
| 1969 | 1.1152 | 1.0071 | 1.3541 | 1.0120 | 1.1226 |
| 1970 | 1.1193 | 1.0000 | 1.3445 | 1.0000 | 1.1094 |
| 1971 | 1.1416 | 0.9232 | 1.2412 | 0.9522 | 1.0564 |
| 1972 | 1.1952 | 0.8547 | 1.1491 | 0.9203 | 1.0210 |
| 1973 | 1.3615 | 0.7354 | 0.9888 | 0.8650 | 0.9596 |
| 1974 | 1.4004 | 0.7136 | 0.9594 | 0.8571 | 0.9508 |
| 1975 | 1.2157 | 0.7847 | 1.0551 | 0.9438 | 1.0470 |
| 1976 | 0.9963 | 0.8663 | 1.1647 | 1.0156 | 1.1267 |
| 1977 | 0.9708 | 0.8270 | 1.1119 | 0.9613 | 1.0664 |
| 1978 | 1.0378 | 0.7438 | 1.0000 | 0.9014 | 1.0000 |
| 1979 | 1.0229 | 0.7390 | 0.9936 | 0.9095 | 1.0090 |
| 1980 | 0.9742 | 0.7513 | 1.0101 | 0.9583 | 1.0632 |
| 1981 | 0.8700 | 0.8056 | 1.0831 | 0.9906 | 1.0990 |
| 1982 | 0.7519 | 0.8507 | 1.1437 | 0.9786 | 1.0856 |
| 1983 | 0.6688 | 0.9201 | 1.2371 | 0.9987 | 1.1079 |
| 1984 | 0.5785 | 1.0448 | 1.4048 | 1.0900 | 1.2092 |
| 1985 | 0.4984 | 1.0879 | 1.4627 | 1.0504 | 1.1653 |
| 1986 | 0.5253 | 0.9292 | 1.2492 | 0.9390 | 1.0417 |
| 1987 | 0.5922 | 0.7385 | 0.9929 | 0.7970 | 0.8842 |
| 1988 | 0.6560 | 0.6516 | 0.8761 | 0.7628 | 0.8462 |
| 1989(1Q) | 0.6193 | 0.6876 | 0.9245 | 0.8320 | 0.9230 |
| 1989(2Q) | 0.5984 | 0.7082 | 0.9522 | 0.8165 | 0.9058 |
| 1989(3Q) | 0.5862 | 0.7147 | 0.9609 | 0.8179 | 0.9073 |

Above 1.00 = Undervalued  Below 1.00 = Overvalued

## FOREX RATES & UPDATE

| Currency | Spot | 3-Month | 12-Month | Comments vis à vis US$ | Comments vis à vis DM (Spot DM: 1.6880) |
|---|---|---|---|---|---|
| Australian dollar | .7705-.7715 | .7587-.7602 | .7280-.7300 | Neutral | Neutral |
| Belgian franc | 34.72-34.77 | 34.81-34.96 | 34.89-35.34 | Remain long | Neutral |
| Danish krone | 6.4150-6.4200 | 6.4545-6.4665 | 6.5375-6.5600 | Remain long | Remain long |
| Dutch guilder | 1.8915-1.8925 | 1.8915-1.8928 | 1.8925-1.8950 | Remain long | Neutral |
| Greek drachma | 163.95-164.05 | 168.45-172.55 | 180.95-198.05 | Remain short | Remain short |
| Hong Kong dollar | 7.7925-7.7975 | 7.8105-7.8145 | 7.8555-7.8705 | Neutral | Neutral |
| Irish punt | 1.5880-1.5895 | N/A | N/A | Remain long | Neutral |
| Italian lira | 1234-1235 | 1244-1248 | 1276-1283 | Remain long | Liquidate |
| Kuwaiti dinar | .29330-.29360 | .29310-.29350 | .29145-.29315 | Neutral | Neutral |
| Malaysian ringgit | 2.7175-2.7185 | 2.7130-2.7175 | 2.7085-2.7165 | Neutral | Neutral |
| Norwegian krone | 6.5270-6.5320 | 6.6285-6.6485 | 6.7030-6.7405 | Remain long | Neutral |
| Portugese escudo | 149.35-149.45 | 152.05-152.60 | 160.85-164.95 | Neutral | Neutral |
| Saudi Arabian riyal | 3.7500-3.7510 | 3.7475-3.7500 | 3.7520-3.7560 | Remain short | Remain short |
| Singapore dollar | 1.8745-1.8755 | 1.8700-1.8730 | 1.8565-1.8665 | Neutral | Neutral |
| Spanish peseta | 106.33-106.43 | 107.75-107.93 | 111.93-112.23 | Remain long | Neutral |
| Swedish krona | 6.0975-6.1025 | 6.1710-6.1795 | 6.3925-6.4125 | Remain long | Neutral |

**Explanatory Notes**

*Indicates change in recommendation from last issue.

| | | |
|---|---|---|
| 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

**Wednesday, March 28:**
Due to technical difficulties, there was no update yesterday. The market letter is in the mail. Please note one omission. Retain spread positions of long SF and short DM. Next regular update Friday, March 30.

**Friday, March 30:**
One new recommendation. Buy July corn at market, placing initial stops at 259, close only.

**Flash Update, Monday, April 2, 1:10 pm:**
Cover immediately all short gold positions at market. We will hopefully reinstate short positions on the next rally.

**Tuesday, April 3:**
There are no changes or new recommendations. We are repeating the flash update from Monday, April 2: Cover immediately all short gold positions at market. We will hopefully reinstate short positions on the next rally.

**Friday, April 6:**
There are no changes or new recommendations. Next update Monday, April 9.

**Monday, April 9:**
There are no changes or new recommendations. Next update Thursday, April 12.

**Thursday, April 12:**
There are no changes or new recommendations. Next update Wednesday, April 18.

**Wednesday, April 18:**
There are no changes or new recommendations.

**Friday, April 20:**
There are no changes or new recommendations.

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