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The bear's yen-fest

Like any good big-sized bear, the Japanese bear needs food to keep on prowling. Fortunately, the last batch of statistics was, by any standard, a real fest.

First came news that Japan's money supply (M2 and CDs) rose by an adjusted 2.1% in April, a 13.2% year-on-year rise. This was the highest increase since December 1976 when the figure showed a 13.8% rise. The usual "explanations" were forthcoming (they hate rising interest rates, don't they?): a shift of money from Postal savings (a large amount of which matured last month), not covered by statistics, into money instruments; a shift of government money into the financial markets; etc. Be that as it may, "transaction" money in circulation is soaring, and it can't possibly be any good. Rising money supply growth has been fuelling domestic demand, with negative effects on inflation, the yen, interest rates, and the current account.

The next morsel was the 0.6% rise in April's wholesale prices, following the 0.7% rise for March. Again, here the apologists had us focus on the modest 2.7% year-on-year rise. But the two-month figure annualizes to an 8.08% rate, over 100 basis points higher than the yield on 10-year instruments!

The wholesale price indices contained an interesting breakdown: Export and import prices were up an astonishing 2.1% for the month, clearly a result of the sliding yen. No wonder the Minister of Finance is desperately seeking to halt the currency depreciation. But has a patient ever recovered by breaking the thermometer?

The dessert was impressive but totally expected: The trade surplus resumed its downtrend, falling 51.4% from the year before. Exports fell 5.8% to \$21.87 billion from \$23.22 billion a year earlier, while imports rose 15% to \$18.33 billion from \$15.93 billion last April. In March, the trade surplus had increased for the first time in nearly a year, rising 7.2%. Speaking half-truths, the Finance Minister said that both April's sharp decline and March's increase on the surplus were in large part due to distortion caused by the imposition of a 3% consumption tax in April '89, causing March '89 imports to swell and April '89 imports to collapse. The entire truth lies, therefore, in the aggregate *March-April* figures: a \$10.63 billion surplus in 1990 versus a \$13.90 surplus in 1989, or a 23.5% fall. A simplistic projection for 1990 yields a trade surplus of \$51.5 billion, down from \$77.1 billion in 1989 and \$95.5 billion in 1988.

Japan's basic balance, i.e., the sum of its current account balance and net inward foreign direct investment and portfolio investment in bonds or equities, which last year was negative to the tune of 1.1% of GNP, should continue to deteriorate as low or nil real returns in Japan spur further capital exports. Thus far, the drop in international reserves has offset the net outflows. As outflows accelerate, the BOJ will have to accept a sharply lower currency or sharply higher interest rates (to attract short-term capital and deflate domestic demand) or a combination thereof.

The Japanese bear is alive and...growling. Despite temporary detours caused by outright official manipulation (such as last week's sharp but ephemeral rally in currency, bonds, and stocks (see close-up Charts 1 and 2), the yen is heading much lower, interest rates will skyrocket, and stocks will collapse.

STRATEGY: *Maintain our favorite cross-trade: short Japanese yen/long Swiss franc. The recent dip (see Chart 3) provides an excellent entry point for accounts wishing to add to the position.*

Remain short the 10-year 6% government bond traded on the LIFFE. Our old 96.75 stop served us well, mindful of the

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

ever-present probability of official manipulation. Roll over to September '90 and lower stops to 96.25, close only.

The Nikkei 225 Index is heading lower in a hurry. The quiet range around 3200 during the past week is an indication

that the deeply oversold condition reached in late March has been corrected and new buying power has been exhausted. The next short term target is 24,000; ultimately, the Nikkei will fall below 16,000.

Chart 1
LIFFE Japanese Bond – Jun 90

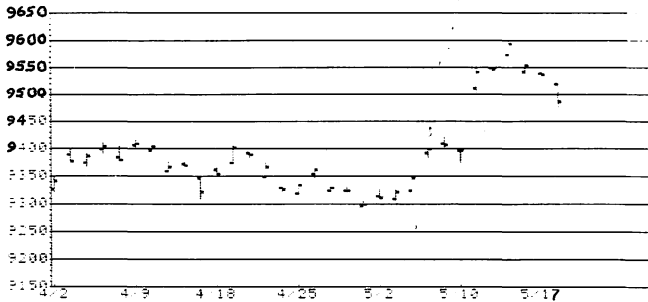


Chart 2
CME ¥ Jun 90

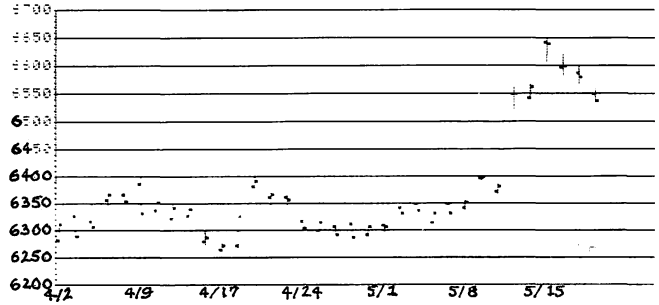


Chart 3
Swiss franc/¥ Jun 90

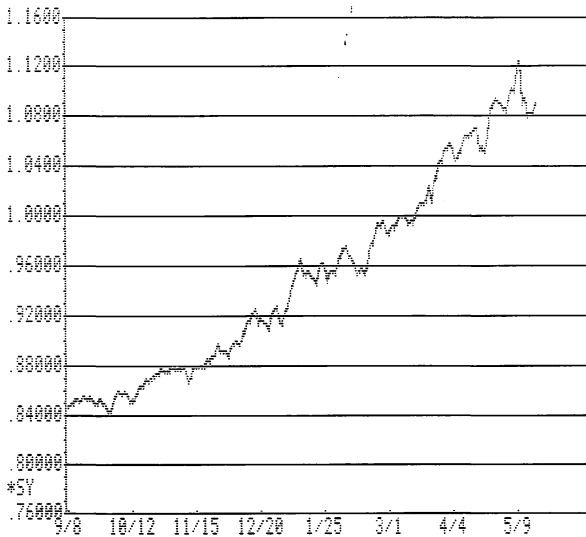
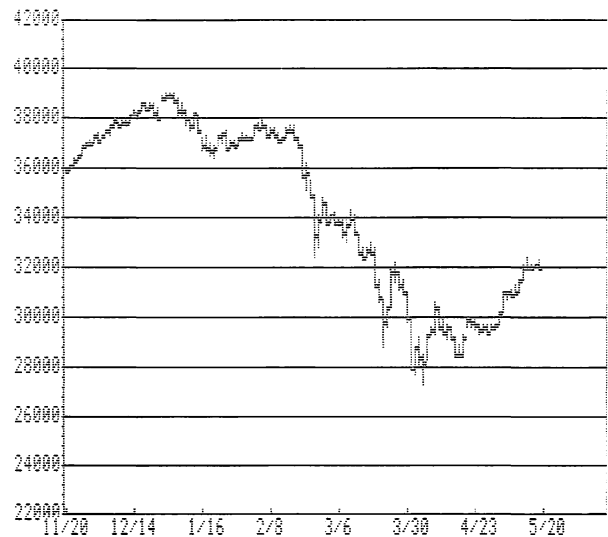


Chart 4
Nikkei 225 Index Spot



THE ECONOMY

A Bush attack on supply-side spreads

With the exception of our grouching about the fact that the Bush Administration has rather arrogantly refused to address the source of the savings and loan mess, namely government-funded deposit insurance, and the fact that the White House never misses an opportunity to voice concerns about the Fed's Wicksellian (flat yield curve) policy, we have avoided comment about the Administration's economic policies. Instead, we have waited to see if a grand pattern of economic policy that would significantly alter the nation's long-run fundamentals would develop. We are now certain that such a

pattern is developing. In consequence, it is time to blow the whistle on President Bush and his band of poll-watching underlings. After all, President Bush's brand of economic policies attack our great totem of the economy's health: the supply-side spreads.

Uttering the "T-word"

After more than three months of inaction on the 1991 federal budget, President Bush has motivated movement. To accomplish this, all he had to do was utter the "T-word" (taxes).

Indeed, the President indicated that budget negotiations would begin with everything on the table, including new taxes.

Apparently, federal revenue and spending trends during the past six months have panicked the Bush Administration: Slow economic growth, coupled with a mega S&L bailout have resulted in federal revenue increases of 4% and a spending surge of 7%.

In consequence, if current trends continue, the 1990 deficit could come in at \$191 billion, which is \$91 billion over the Gramm-Rudman-Hollings (GRH) target. If this should occur, the automatic sequester provision of the GRH would kick in. This would force automatic spending cuts to meet the GRH target, with 50% coming from defense and the remainder from domestic programs. Wanting to avoid the spending meat ax, President Bush has put new taxes (perhaps \$30 to \$40 billion?) on the table.

Before we comment on the implications of such an eventuality, it is vital that we put GRH and federal budget trends into perspective. In part, this is required because most politicians and political pundits, as well as members of the financial community, have never been able to analytically or empirically put GRH and the federal deficit issue into a proper perspective. For these folks, deficits are little more than a convenient whipping boy for whatever happens to be ailing them.

With the exception of those who follow our supply-side spreads, the US economy has fooled everyone. Despite all the talk about budget deficits, we are in the middle of the eighth year of a record-setting expansion. One reason for this is the fact that federal spending — which is the only budget-related item that crowds out productive, private activity — has been falling as a percent of GNP. Indeed, since 1985 that share has fallen from 23.9% to a projected 21.8% in the current year, and an estimated 20.9% in fiscal 1991 (see Chart 5).

While it is true that the deficit has been stuck at about \$150 billion since 1987 and the GRH targets have been missed, it is also true that the deficit's share of GNP has plunged by 57% (from 5.4% in 1985 to 2.3% projected for this year; see Chart 5).

This collapse in the deficit's share of GNP has resulted largely because of a massive slowdown in federal spending growth. For example, from 1973 to 1985, spending rose at an average annual rate of about 4%. But since GRH, spending has risen by 1.4% per year, and only 1.3% in the last four years (Chart 5). This represents the greatest slowdown in spending in the 20th century. The no new taxes pledge, in combination with the GRH and its automatic sequester provision, has worked. Indeed, it has greatly assisted in keeping the expansion alive.

If President Bush signs on to a budget deal that includes \$30 to \$40 billion in new taxes, the "cap" on federal spending will be lifted. In consequence, productive private activity will be displaced and our supply-side spreads will be squeezed.

To appreciate this, assume that the rate of return on

capital is 10% per annum and that new taxes will be \$30 billion. Given tax capitalization — which is understood by few in Washington, D.C., with the exception of our supply-side friend, Mr. Warren Brookes — this implies that \$300 billion of the nation's capital stock will be nationalized (destroyed).

To put this number into perspective, consider that additions to net fixed nonresidential investment for the US are running at about \$100 billion annually. Hence, new Bush taxes could easily wipe out the equivalent of about three years' worth of additions to the nation's nonresidential investment stock. It doesn't take much economic sophistication to see that this would hit productivity hard. Hence, our supply-side spreads would be squeezed because the output (value) side of the spread would be lowered and the input (cost) side would be increased.

Burning neckties

Unfortunately, the prospect of a new tax attack on supply-side spreads is not the end of the Bush policy story. In a study, *Social Regulation: A Report Card*, which was published last month by the US Chamber of Commerce Foundation, Dr. S.J.K. Walters and I document the fact that Bush Administration has been quietly tuning back the clock on President Ford's, Carter's, and Reagan's deregulation efforts. Symbolic of the Bush-inspired reregulation effort was a recent ceremonial burning of Adam Smith neckties, which was held at the Interstate Commerce Commission.

At the cutting edge of President Bush's reregulation efforts is his environmental policy. In this sphere, the big ticket item is the Clean Air Act that is making its way through Congress. We believe that the President, for all his posturing, will sign a Clean Air Bill when it arrives on his desk later this year.

The Clean Air Act will probably be the most damaging regulatory attack that the supply-side spreads have ever encountered. To appreciate this, consider the "Permitting and Enforcement" titles of the Act. They will give the Environmental Protection Agency (EPA) a chokehold over all but the tiniest businesses and every new idea, product, or process. Virtually every business move will require an EPA permit. Moreover, even if the EPA police are inclined to grant a permit, businesses won't be off the hook because any citizen group — from those that represent environmentalists to foreign competitors — will be able to sue to stop permits from being issued.

Needless to say, the Clean Air Act, which will eventually be translated into at least 12,000 pages of regulations, will be the most anticompetitive weapon ever developed against American business. In consequence, productivity will be under heavy pressure, and the supply-side spreads will be severely squeezed. If this conclusion is doubted, consider that the less stringent safety and environmental regulation imposed during the 1970s accounted for between 30% to 50% of the decline in US productivity that occurred in that decade of stagflation.

Implications

Our supply-side spreads fell in each quarter of 1989. In the first quarter of 1990, the spread is an anemic +0.1%. If our projection of President Bush's policy course is correct, he will sign off on new taxes and more environmental regulations. In consequence, productivity will be hit hard, and our spreads will struggle to register positive readings. With the specter of stagflation, it will be more difficult to attract foreign capital to the US, as well as retain domestic capital. This would spell big trouble for the dollar. Need we say more?

— Dr. Steve H. Hanke

Chart 5
Federal Budget Indicators

	Deficit (% GNP)	Fed spending (% GNP)	Annual Spending Increase (%) – Last year of a 4-yr. running average
Before Gramm-Rudman-Hollings			
1973	1.2	19.2	0.8
1977	2.8	21.2	4.2
1981	2.6	22.7	3.9
1985	5.4	23.9	4.0
After Gramm-Rudman-Hollings			
1989	3.2	22.2	1.6
1990 proj.	2.3	21.8	1.3
1991 est.	1.1	20.9	1.2

Source: US Federal Budget

INTEREST RATES

Prof. Wicksell and the money supply

The April 28, 1990, issue of *The Economist* carried a piece entitled "Dr. Wicksell, We Presume." It verified that we have been correct in our insistence that the Fed, under the intellectual leadership of Vice-Chairman Johnson and Governor Angell, has become Wicksellian. As we anticipated, this brought a quick response from a certain influential segment of the supply-side community — in particular, that segment that tends to favor lower interest rates. For example, Mr. Alan Reynolds, writing for Mr. Jude Wanniski's Polyconomics, Inc., concludes in "Do High Bond Yields Always Mean Inflation?" (May 10, 1990), that Professor Wicksell's "simple rule [is] a bit too simple to provide much help to the Fed." And that Vice-Chairman "Johnson's attention to bond yields and yield curves is potentially very misleading." Needless to say, we disagree with Mr. Reynolds conclusions.

Our disagreement stems from the fact that Mr. Reynolds mischaracterizes Professor Wicksell's theory and policy prescriptions. To make his point, Mr. Reynolds uses the well-known monetarist criticism that the *level* of the interest rate (the Fed funds rate) is not an accurate policy indicator. As he states, "Yet an increase in central bank interest rates is, at best, a mediocre proxy for tight control on the volume of new bank credit and cash." We agree, and so would have Professor Wicksell.

We, along with Vice-Chairman Johnson, know that for Professor Wicksell, it was the interest rate *spread*, not the *level* of the interest rate, that counts. Moreover, as the Vice-Chairman's assistant, Dr. Robert Keleher, notes, "The yield spread is *not* an indicator of the *effects* of changes in policy, rather it constitutes an incentive mechanism that itself *creates* changes in monetary stimulation or contraction." Indeed, a change in the Fed funds rate, *if it alters the interest rate spread (yield curve)*, works to change the incentives affecting money creation.

Common ground

Wicksellians and monetarists, therefore, have more in common than might appear at first glance. In analyzing the

money supply process, monetarists focus on reserve control. They also stress the valid dangers of using the *level* of interest rates as a policy target. Hence, they are reluctant to give the Fed funds rate any role as a monetary policy instrument. Moreover, monetarists tend not to give the Fed funds rate any weight as an indicator of monetary policy changes.

The Wicksellians are also interested in the money supply process. For them, the money supply also matters. However, rather than focusing on the monetarists' rather mechanistic reserves-to-money multiplier, Wicksellians focus on the relationship between the Fed funds rate and longer-term rates (the yield curve). Instead of reserve growth, the Wicksellians believe that the money supply process can be best understood and controlled by *market incentives* as manifest in interest rate *spreads*. For Wicksellians, the *spreads*, not the level of reserves, are the proximate determinant of changes in deposits and money.

To understand the merits of the Wicksellian *market-based approach* to money supply control, we must recognize that money is created or extinguished when banks acquire or sell assets. Hence, to understand what determines changes in the money stock, we must analyze what makes banks buy and sell assets.

Banks respond, as do other profit-maximizing enterprises, to the marginal cost and marginal return on funds. Hence, when the spread between the marginal cost (Fed funds) and marginal return (longer-term yields) expands, banks tend to create money by expanding their loans (assets), and vice versa. Thus, by influencing yield spreads via changes in the Fed funds rate, the Fed can control the bank's incentives that create or extinguish money. Wicksellians, therefore, control changes in the money supply by altering the shape of the yield curve, instead of by targeting changes in banks' reserve position.

The superiority of using the Wicksellian *market-based* or *incentive* approach to monetary policy can be appreciated by realizing that a bank alters its portfolio depending on what is profitable, not on its reserve position. After all, if a profitable lending opportunity arises, a bank can make a loan re-

ardless of its reserve position, because it can always finance such a loan in the reserve market. In consequence, the proximate determinant of changes in deposits and money is the *spread* between Fed funds and the marginal return on bank assets (longer-term yields), not the level of its reserves. Hence, *the yield spread is the cutting edge of the money supply process.*

If this weren't enough, by targeting interest rate spreads (*market price data*), rather than the monetarists' *quantity data*, the Wicksellians capture information contained in the market. This information, as Vice-Chairman Johnson noted in a recent speech in London, is extremely valuable: "Since market prices embody expectations of the future, they are inherently forward looking, offering a distinct advantage over any form of quantity data. This is a particularly important quality for monetary policymakers who necessarily must be forward looking in their decisions."

Wicksellians, like monetarists, are vitally concerned with the money supply process. As Wicksellians, we conclude that *yield spreads*, which are prices generated in markets, offer the most valuable insights into the incentives that determine changes in bank deposits and money. In consequence, yield spreads provide useful monetary targets and are excellent indicators of the Fed's monetary stance.

Conclusions

Our *Yield Stress Index* registers "stress" when there is a misalignment between long and short rates. Last month, short-term rates registered a -26 basis point stress; therefore, the yield curve was "too steep" by about 25 basis points. At present, the short-term rates are registering a -38 basis point stress; therefore, the yield curve is "too steep" by about 40 basis points.

— Dr. Steve H. Hanke

INTEREST RATE FUTURES

The worst of both worlds

Contrary to popular belief, as the foregoing article makes clear, the Fed is far from being "tight." The progressive widening of the *Yield Stress Indicator* has been reflected in a sharp expansion of adjusted federal reserve credit and adjusted monetary base. In the past two months, the latter has been expanding at a rapid 10.1% per annum.

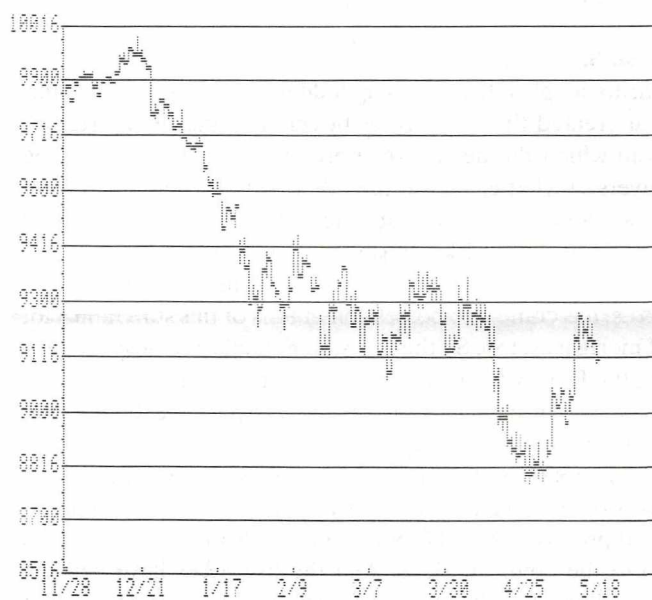
The Fed may be deliberately following this course of action in view of the extremely sluggish pace of economic activity as well as the catastrophe affecting the S&L and banking industries. (The mess is not about to go away. See "The Commercial Bank Bailout of 1995" on page 6 for a perceptive view of the new dangers lurking.)

Signs abound that the monetary easing is counterproductive: The Commodity Research Bureau Index is making new 14-month highs; consumer prices increased at an annual rate of 8.5% for the first three months; the US dollar is making new multi-year lows *vis à vis* the Swiss franc and the European Monetary System.

The US is about to experience the worst of both worlds: stagflation (see "The Bush Attack on Supply-Side Spreads" on page 2) and rising interest rates. On a more positive note, the banking system is continuing to reliquify (see FC&CC March 1990 and October 1989); the build-up in liquidity should *eventually* fuel the next inflationary boom. We are not there...yet.

STRATEGY: Add to previously established December '90 Eurodollar 91.50 puts; buy September '90 and December '90 slightly-out-of-the-money T-bond puts.

Chart 6
CBT T-bond (day) Sep 90



The commercial bank bailout of 1995

By Martin Mayer

Legend tells of the traveler who went into a country store and found the shelves lined with bags of salt.

"That's a lot of salt," said the traveler to the storekeeper.

"You think *that's* salt," said the storekeeper, and led his visitor to the cellar, which was stacked high with bags of salt.

"You must sell a lot of salt," said the traveler.

"Nah," said the storekeeper. "I can't sell no salt at all. But the feller who sells me salt—boy, can *he* sell salt."

What brings this story to mind is the sight of tens of billions of dollars in mortgage securities stacked in the cellars after the S&L collapse.

They come in great variety. Some represent ownership of a whole horse, packages of real mortgages such as an ordinary investor's Ginnie Mae pass-through. Many others are "derivative" securities, "strips" or "tranches" of mortgage packages, reporting claims on just the interest payments, just the early repayments of principal, just the late repayments of principal, just whatever's left after all the other tranches get paid, etc. Owen Carney, deputy national bank examiner for the New York area, told a conference the other day that the first "collateralized mortgage obligation" he saw—in the early 1980s—had four "tranches," while the most recent one he's looked at had 47. A lot of those 47 are the rear part of the horse.

A sure thing

Thriffs supplied the necessary fodder to the investment banks that created these securities by selling them the mortgages from which the derivatives were made. And they were big buyers of what came out the other end. The salesmen from those same investment banks told them they were getting a sure thing—safe, risk-adjusted high returns.

The Resolution Trust Corporation, as receiver for dead S&Ls, has come into possession of tons of this stuff, and a lot of mortgages, too. So the investment banks are busy colonizing the RTC, which likes the idea that it can get more for its mortgages by paying fees to people who package them than it would get simply by selling the paper.

The RTC is under pressure to sell, because Congress and investors in government securities are getting restless about what promiscuous RTC borrowing for "working capital" will do to the credit markets. And the live S&Ls have become net sellers, too, because the easiest way to improve their ratios of capital to assets is to sell assets.

So who's buying? Why, the commercial banks, of course. They're stocking up. At the nation's banking trade shows these days, presentations on the assured risk-adjusted profitability of mortgage-backed securities have become the most glamorous entertainments on the schedule. Every once in a while, somebody asks a nasty question, like, "if this stuff is so liquid, why do you make it so costly for me to do a repurchase

with you?" But mostly the show goes over well.

At the end of 1986, commercial banks held a total of \$37 billion in mortgage-backed securities. By September 1989, they held \$120 billion, and counting. The numbers clearly are beginning to worry the Comptroller of the Currency. Last week Wall Street buzzed with rumors, which were not denied, that the comptroller has plans to forbid banks to buy some of the most cleverly carved cuts of the mortgage-sellers' horses.

From a bank's point of view, a mortgage security has three great virtues. As a practical, day-to-day matter, it's an easy place to put money in a time of poor loan demand. In Texas, for example, NCNB, Banc One and Texas Commerce have been scrapping for deposits but have no local use for them, so they buy a lot of mortgage securities. From December 1988 to September 1989, NCNB went from \$300 million to \$6.9 billion in holdings of such securities.

Then, for purposes of the Basel accords, which set minimum capital standards for banks world-wide, these securities are government-insured mortgages, which means they have a "risk weighting" of only 20%. To keep faith with Basel, a bank must put \$30,000 of stockholder money into each million-dollar commercial loan. To carry a million-dollar mortgage security, however, the bank needs only \$6,000 of equity.

Finally, mortgage securities yield more than treasuries, and the closer the tranches get to the rear of the horse, the greater the yield. With securities representing strips of adjustable-rate mortgages, a bank can claim almost any yield it likes, because auditors and examiners will not enter the analytic nightmare of calculating the real accretion of value in such instruments.

The bank examiners have no proclaimed standards for a capital cushion to be kept against interest-rate risk. It's understood that a modern bank will hedge such risks, and the same gentlemen who sell the banks the securities will also sell them hedges—at a spread maybe four-times what the bank would have to pay to buy a combination of Treasuries and exchange-traded futures and options. After all, as the salesmen point out, it's a customized service: You're getting exactly the tranches you need, and you can be confident of that because we tell you so.

In theory, the tranches nearer the tail lose their preferential weighting on the Basel scale, but first the examiner has to find them, and then he has to withstand the argument that, hell, we've hedged the risk. "Hedging" is a term of art in bank examination. It means not that some economic substance has been protected, but that there is a "Memorandum to File" stating that a hedge has been purchased and meets some artificial statistical condition.

All mortgage paper has mysterious options embedded in it, because homeowners can pay off their loans at any time

for any reason. Pricing these options is a highly technical skill, and banks (let alone bank regulators) are not likely to pay as much for such skills as the people in the investment banks who design and sell such instruments. "Regulators who let naive banks buy mortgage securities," says Sri Sankaran of SRI Inc., a Chicago-based options-analysis company, "are like the Red Cross sending hospitals blood donations from drug addicts; they're spreading a fatal disease."

Most businesses that leverage their equity 150 to 1, which is what the Basel rules permit for holdings of these securities, live on the edge of a cliff. But banking regulators make things look all right by permitting banks to claim the house still stands even if the sea eats away its foundations. Banks can continue to carry securities in their investment portfolio at whatever was paid for them, even if the market price goes down. Concealment of losses, approved by the regulators, was what made the S&L disaster unmanageable.

Additional capital

There are two ways to keep this slippery slope from plunging the taxpayer into a commercial bank bailout. The first is a

requirement that everything in a bank's portfolio for which there is a market be marked to the market price every night. The second is that additional (not reduced) capital be required from every bank that wants to buy strips or lesser tranches of mortgage-backed securities. These procedures are roughly what the Shadow Financial Regulatory Committee has recommended.

Purchases of the tail ends from the manufacture of mortgage securities—what the Salomon Brothers salesmen, according to Michael Lewis in "Liar's Poker," called "toxic waste"—produced billions of dollars of losses at the S&Ls. The comptroller is right to be worried at the sight of so much of this stuff moving from the S&Ls to the banks. If he doesn't move soon—and carry the Fed and the FDIC with him—the legislative draftsmen had better get started writing the Commercial Bank Bailout Bill of 1995.

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CURRENCIES

A dollar sell-off?

Last month we stated that "our sense is that the US dollar is under pressure, threatening to break to new lows, *vis à vis* the EMS." In the intervening four weeks, the European currencies, and more particularly the Swissie, have scored multi-year highs against the US dollar (see Chart 7), validating our bet.

Ailing the dollar are the twin ills of stagflation (see "Bush attack on supply-side spreads," on page 2) and monetary "looseness" (see articles on interest rates). In addition, we suspect that a new element will come into the picture: a distrust by foreigners of the US banking system, especially if the too-large-to-fail policy is abandoned, as officials are indicating, and a large bank goes under. The subsequent withdrawal of funds may or may not affect the US dollar.

In the medium term, holders of deposits may switch to: a) Treasury bills and/or b) dollar deposits at non-US banks (Swiss, British, German) and/or c) non-US dollar deposits. Visions of a gigantic and inflationary bail-out operation may lead depositors to give high preference to the last alternative; to that extent, the dollar will suffer. In the short run, however, there is little doubt that a banking panic will lead to a serious dollar sell-off.

STRATEGY: *Which currencies will benefit most? In our previous issues, we have favored the Swiss franc and the*

British pound.

The Swissie is underpinned by a very firm monetary policy (see Chart 8, where year-on-year M1 remains negative) and consequently high interest rates (around 9% for three-month deposits, almost 100 basis points higher than corresponding DM rates).

Our bullish view of the Swissie has led us to recommend in recent months the long SF/short DM cross, with excellent results (see Chart 9). Last month we suggested long outright Swiss franc, with stops at 65.40 and cheap, out-of-the money calls. Retain all these positions.

The British pound has been strengthening, also underpinned by high interest rates, and more recently, by official indications that Sterling was about to enter the EMS. We believe that sooner rather than later the UK will join the exchange rate mechanism (ERM) of the EMS, if only for political reasons: Mrs. Thatcher's need to steal Labor's thunder. The trick will be a) the entry level and b) the fluctuating margin.

Whatever the decision, we are willing to bet that the bottom of the band will not be lower than a cross rate of DM2.74. If so, continued purchase of forward Sterling should prove highly profitable (December '90 Sterling trades at an implicit cross of DM2.6880). Remain long outright positions, and raise stops to 161, basis June, close only.

Chart 7 – CME Swiss Franc Jun 90



Chart 8

SWITZERLAND

Year-Over-Year Rates of Change of
Money Supply
&
Consumer Price Index

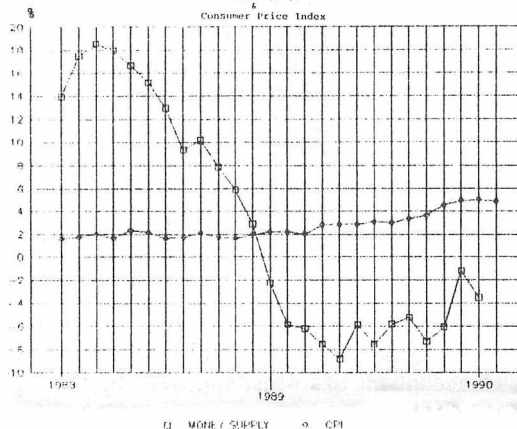


Chart 9 – DM/SF Jun 90

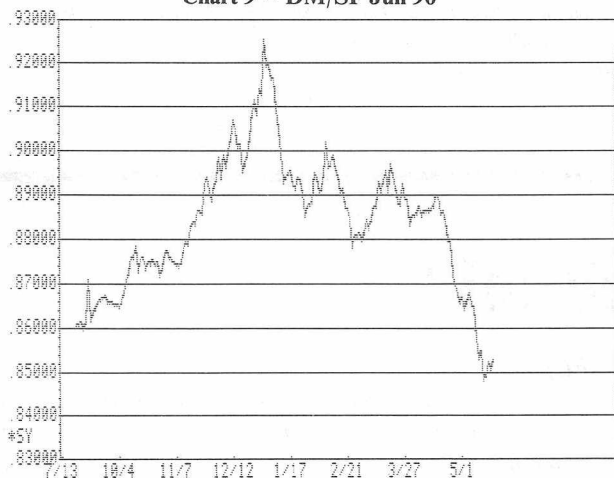
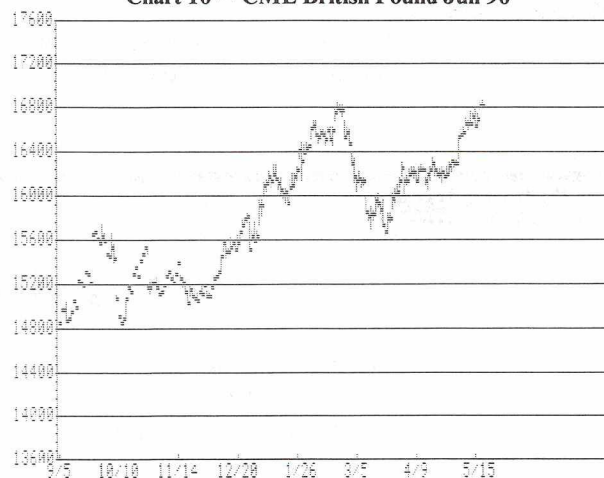


Chart 10 – CME British Pound Jun 90



STOCK INDEXES

Denting the bear scenario?

Led by the large-capitalization stocks, the market proved the old adage that it will always do the least expected thing, and went on to score new all-time highs in the Dow Jones Industrials. The S&P 500 is within 2% of its all-time high. In contrast, the broader and more comprehensive Value Line Index is still 8% below its old October '89 highs (see Chart 11).

Although the bear market scenario remains intact, it has been dented somewhat: declining corporate profits with no improvement in sight; rising interest rate prospects (see Interest Rates); and excessive valuations (PEs too high relative to bond yields, historically low dividend yields, historically high price/book value ratios).

On the other hand, it is important to note that the Fed has been easing aggressively: The adjusted monetary base has been growing at a 10.1% annual pace in the two most recent months compared to a year-on-year trough at 3.3% last August.

Since money makes the mare go, it is unlikely that in this

environment we'll see collapsing stock prices, *even* if the cost of money rises further. Chart 12 is quite explicit — stocks have been gaining *vis à vis* bonds ever since the fateful post-October '87 days and are now approaching the relative overvaluation levels last seen before the crash.

The last relative overvaluation was accompanied, however, by a sharp *deceleration* of money supply that ultimately triggered the crash. This time, the relative overvaluation is being accompanied by a slight acceleration of money supply. Only by observing the market's reaction to "bad news," i.e., rise in Fed funds, drop in dollar, sharp fall in Japanese stock prices, will we be able to conclude whether this overvalued market will become a great deal more overvalued or whether sanity will return.

STRATEGY: *We remain short June '90 Value Line and long S&P put options. Keep in close contact.*

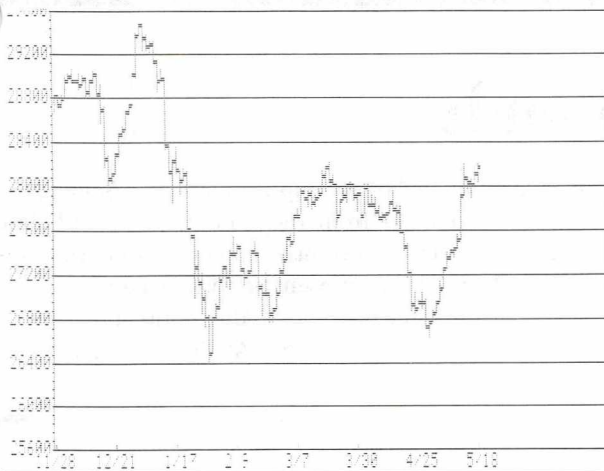
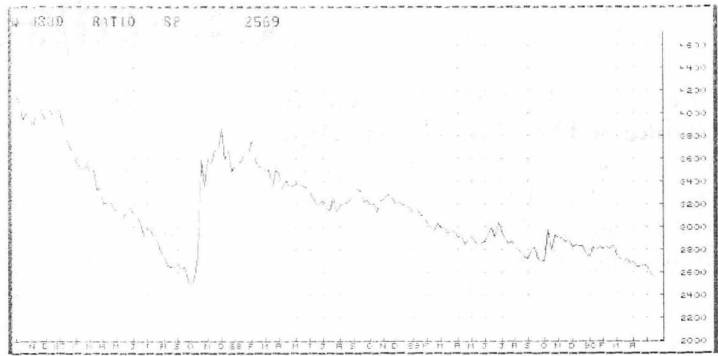


Chart 12
US BOND/S&P SPOT



CRUDE OIL

Tilting to the bear?

The rapid contraction in the record high six-month contango (June '90 to December '90, see Chart 13) more than the Opec pledge to cut 1.445 million barrels/day (b/d) persuaded us to cover our short positions and liquidate our long puts, thus accepting substantial profits (see Hotline Update of May 9).

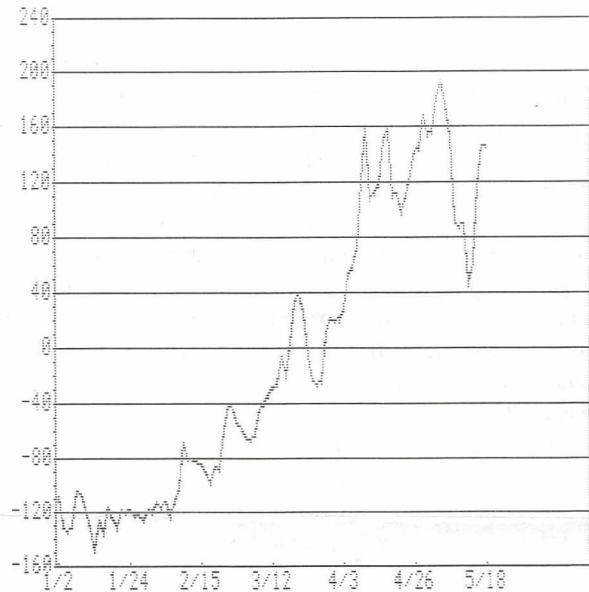
As suggested last month, Opec must not only cut back production to meet current demand (estimated by the International Energy Agency to be 20.5 million b/d) but it must also deal with an overhang approaching 400 million barrels.

Mathematically, this can be accomplished by additional cutbacks equal to 2.5 million b/d (below the 20.5) for as long as five months, or 5 million b/d for 2.5 months, or combinations thereof.

As it stands now, the agreement lowers Opec production to, at most, 22 million b/d, provided a very reluctant Kuwait plays along. Not only is there no progress in dealing with the current overproduction but also the overhang is certain to grow. The most recent deterioration in the six-month spread may be signalling new trouble ahead for oil producers.

STRATEGY: Our temporary sidelined position is starting to tilt to the bear side. By the time you receive these comments, you may have been advised via the Hotline service to reenter the short side of the market. Keep in contact.

Chart 13 - Crude Oil Dec-Jun



POTPOURRI

On Brazil, platinum, gold, and corn

Early prediction: We are forecasting the total failure of Brazil's new economic plan ordered by Mr. Collor de Mello (see last month's initial coverage of the Plan in *Friedberg's LDC Debt Comments*); a serious economic and political crisis will follow, and ultimately, the possible return of the military...Serious labor

unrest at the South African Mines should be extremely bullish for the oversold precious metals group; our true favorite, platinum...Nevertheless, gold should have a decent run too... We had a profitable trade in corn, bought at around 2.65½ and sold at around 2.90. Keep in close contact for possible re-entry.

FOREIGN CURRENCY BONDS

Gilt-edged bonds

Index-linked gilt 2%, due September 16, 1996, trading at 158, 92.02% of parity

The indexation of investment instruments is a relatively new idea in England. In 1975, the Labor government used index-linked savings certificates (granny bonds) to preserve and protect the *real* value of savings for pensioners in a period of inflation.

Eventually, index-linked Treasury bonds, or gilts, were issued in 1981 but with a myriad of eligibility restrictions. By 1982, all ownership restrictions were abolished and index-linked gilts have enjoyed steady growth until the present.

Currently the index-linked sector accounts for 11% of the total capitalization of the gilt market, with 13 outstanding issues amounting to over £13 billion. As the specter of inflation looms over the English economy, the index-linked sector of the gilt market will probably grow in both size and importance.

The mechanics of indexation follows some simple conventions, which are essential to an understanding of the index-linked market.

First, all coupons (dividends) and capital repayments (principal) are indexed. Therefore, these bonds do not mature at 100, and coupons change for every interest payment period.

Each issue begins trading with an initial nominal value of 100 and initial coupons of 2% to 2.5%.

Second, the index used for the gilt-edged market is the Retail Price Index (RPI), which is arguably the most widely used and accepted measure of inflation in England (Chart 14).

The reference index for the coupon interest and redemption payments is the RPI for the eighth month before the calendar month of the payment, and base index for given issue is the RPI for the eighth month before the month of the initial issuance. The reason for the lag is the necessity of knowing the next coupon payment (up to 6 months ahead). Therefore, the indexing ratio for coupon payments is equal to

$$\frac{\text{reference index}}{\text{base index}}$$

Another convention that must be noted is that in January 1987, the RPI was 394.5. At that time the RPI was rebased to 100. Therefore, we derive that for any month before January 1987, the base index is rebased by the factor 100/394.5 in order to calculate coupon payments.

To understand the calculations for coupon and redemption amounts, an example is necessary:

1. Coupon calculation of indexed linked 2% Sept. 16, 1996, bond issued March 27, 1981. Coupon dates are Sept. 16 and March 16, e.g., the semi-annual coupon (1%) is due on Sept. 16, 1990:

$$\frac{1\% \times \text{RPI (January 1990)}}{\text{Rebased RPI (July 1980)}} = \frac{119.5}{267.9 \times 100/394.5} = 1.7597$$

As can be seen, the Sept. 16 coupon has risen to 1.7597% of original face value from the initial 1%, because of indexation.

2. The actual principal or redemption amount in September 1996 will be derived from the January 1996 RPI, but because this figure is currently unknown, some assumptions must be used. The present principal value (PPV), or parity, is the amount that will be due notionally if there were an immediate redemption. At the time of writing, using the eight-month lag,

$$\begin{aligned} \text{PPV} &= 100 \times \frac{\text{RPI (September 1989)}}{\text{rebased RPI (July 1980)}} \\ &= 100 \times \frac{116.6}{267.9 \times 100/394.5} = 171.7 \end{aligned}$$

It can be seen that the principal amount has risen to 171.7 from the initial issuance of 100 because of indexation.

An investment in an index linked instrument gives a *real return*. "Real" is used to mean the purchasing power after the dissipation of money value (inflation). In order to calculate real returns on index-linked instruments, some assumptions must be employed. It is necessary to forecast the future stream of payments as yet unknown. In order to calculate future returns for either instrument, some ephemeral assumptions must be employed. As always heuristic truth is only a miner's lamp until a real source of light is found.

How is one to view these bonds?

Calculating the present real rate of return, the 1986 index-linked issue can be purchased at an 8.42% discount from par. The discount from par plus the present coupon produce a 3.4537% annual real return.

Estimating inflation

As can be seen from the accompanying charts, inflation has been a persistent and aggravating problem in the United Kingdom in recent years. At this time the RPI is growing at 8.10% per year. In coming months it is expected to reach 10% per year. Were we to project a similar rate of growth for the six years remaining in this issue, our total return would be 13.45%, which compares favorably with the comparable conventional gilt yielding 12.44%.

In other words the conventional gilt issue contains an implicit inflation forecast of 8.9863% (12.44-3.4537). So, if an investor believes that inflation in the United Kingdom will exceed 8.9863% per year over the remaining six years, he will be well advised to purchase the index-linked gilt.

A US-dollar-based investor is faced with another question — namely, will the inflation rate in England exceed the nominal rate of depreciation of Sterling *vis à vis* the US dollar? Only an affirmative answer to this question should be contemplated by a US-dollar-based investor.

Clients wishing to purchase index-linked gilts should make inquiries to us, as we will be constantly monitoring the market.

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Chart 14
Retail Price Index

12-month percentage growth rate for RPI		
1985	March	6.1%
	June	7.0
	Sept	5.9
	Dec	5.7
1986	March	4.2
	June	2.5
	Sept	3.0
	Dec	3.7
1987	March	4.0
	June	4.2
	Sept	4.2
	Dec	3.7
1988	March	3.5
	June	4.6
	Sept	5.8
	Dec	6.8
1989	March	7.9
	June	8.3
	Sept	7.6
	Dec	7.7
1990	March	8.1

Source: UBS Phillips and Drew
Gilts Research

Chart 15
Money Supply

12-month percentage growth rate for M4 lending		
1985 (1)		14.0%
1985 (2)		13.0
1985 (3)		13.6
1985 (4)		12.9
1986 (1)		14.6
1986 (2)		15.8
1986 (3)		15.8
1986 (4)		15.4
1987 (4)		14.1
1988 (2)		13.9
1987 (3)		14.9
1987 (4)		16.3
1988 (1)		16.8
1988 (2)		16.8
1988 (3)		18.7
1988 (4)		17.6
1989 (1)		18.1
1989 (2)		18.5
1989 (3)		17.3
1989 (4)		18.2
1990 (1)		17.5

Chart 16 - Foreign Currency Bonds

Date: May 17, 1990
We offer the following bonds subject to change without prior notice. Minimum amount US\$5,000 (Gds.\$7,000)

ISSUER/INT./DAYS/COUPON	BID	OFFER	CURRENT ANNUAL YIELD TO MTY	LAST PAY NEXT PAY DATE
CANADIAN DOLLAR DENOMINATED BONDS:				
GOVERNMENT OF CANADA (semi annual) 05/12/90 to 1/4%	98.23	98.53	13.20%	05/12/90-05/06/90
NEW ZEALAND DOLLAR DENOMINATED BONDS:				
CAN. IMP. BANK OF COMMERCE 27/07/92 14% HRP eligible	100 3/4	101 1/2	13.09%	27/07/89-27/07/90
TOURIST HOTEL (N.Z.) 04/06/93 zero coupon	60	62	17.10%	matures -04/06/93
AUSTRALIAN DOLLAR DENOMINATED BONDS:				
COMMONWEALTH BANK OF AUSTRALIA 01/07/94 14%	98 7/8	99 5/8	14.06%	01/07/89-01/07/90
WORLD BANK 15/03/93 12 3/4% HRP eligible	97	97 3/4	13.71%	15/03/90-15/03/91
CAN. IMP. BANK OF COMMERCE 13/03/91 13% HRP eligible	98 3/8	99 3/8	13.52%	13/03/90-13/03/91
DANISH KRONE DENOMINATED BONDS:				
STOCKHOLM 10/11/91 to 5/9%	99 1/2	100 1/4	10.33%	10/11/89-10/11/90
BRITISH POUND DENOMINATED BONDS:				
ROYAL BANK OF SCOTLAND 14/4/93 9 3/8%	90 1/4	91	13.30%	14/04/90-14/04/91
DEUTSCHE MARK DENOMINATED BONDS:				
QUEBEC HYDRO 5 1/2%	83 3/4	84 1/2	8.98%	01/05/90-01/05/91
1/5/96 HRP eligible				
EUROPEAN INV. BANK 5 1/2%	89 5/8	90 5/8	8.99%	09/08/89-09/08/90
9/8/93				
BANK OF NOVA SCOTIA 5 5/8%	83 7/8	84 7/8	9.02%	07/05/90-07/05/91
07/05/96 HRP eligible				
SWISS FRANC DENOMINATED BONDS:				
GOVT. OF AUSTRALIA 30/10/98 5%	84 5/8	86 5/8	7.16%	30/10/89-30/10/90
JAPANESE YEN DENOMINATED BONDS:				
GOVT. OF CANADA 23/7/93 5 5/8% HRP eligible	96.45	97.20	6.63%	23/07/89-23/07/90
U.S. DOLLAR DENOMINATED FIXED RATE BONDS:				
PACIFIC SCIENTIFIC 7 3/4% 15/06/03 (semi) CV \$330 p/sh	71	73 1/2	12.12%	15/12/89-15/06/90
SUNSHINE MEDICAL INC. 7.25% 26/6/96 CV \$517 5/8 p/sh	82	85	10.72%	26/06/89-26/06/90
ALLIANT COMPUTER 7.25% 15/05/12 (semi) CV \$539.75 p/sh	53 1/2	55 1/2	14.16%	15/05/90-15/11/90
COOPER COS. 10 5/8% 01/03/05 (semi) CV \$527.45 p/sh call in 1995 @100	60	70	16.59%	01/08/90-01/09/91
DIGICOR ELECTRONICS 5.5% 1/3/12 (semi) CV \$539.50 p/sh	37	42	14.64%	01/03/90-01/09/90
U.S. DOLLAR DENOMINATED FLOATING RATE NOTES:				
UNITED KINGDOM 24/9/96 3 mo LIBOR-1/8 (rtly) CV \$330 p/sh	99.75	100.05	8 1/4 %	28/03/90-28/06/90
REPUBLIC OF ITALY 30/4/93 3 mo Libson (rtly)	99.50	99.90	8 5/8 %	30/04/90-31/07/90
REPUBLIC OF PORTUGAL 9/12/93 6 mo LIBOR +5 B.P. (semi)	99.70	100	8.2315%	08/12/89-08/06/90
L.A.C. DOLLAR DENOMINATED BONDS:				
ARGENTINA BONEX series 02 6 MO LIBOR (semi) amort. 1/12 of princ./year	82.85	84.35	8.4375%	15/02/90-15/08/90
* IRR				* 28.60%
ARGENTINA BONEX series 00 6 MO LIBOR (semi) amort. 1/12 princ./year	94		8 5/16%	27/11/89-27/05/90
** IRR				** N.A.

For further information and current prices please call:
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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. Rates as of May 17, 1990.

	U.S. \$	NEW ZEALAND \$	AUSTRALIAN \$	DEUTSCHEMARK	SWISS FRANC	JAPANESE YEN	DANISH KRONE	BRITISH POUND
2 year	8.52%	CIBC 14% 27/7/92, yields 13.09% (.528 NZ/US)*					World Bank 9 3/4%, 20/11/92, yields 10.23% (.6459 US/Dkr.)	
3 year	8.58%	Tourist Hotel 0% 4/6/93, yields 17.10% (.4605 NZ/US)	World Bank 12 3/4% 15/3/93, yields 13.71% (.6638 A\$/US)	Euro Inv. Bk. 5 1/2% 9/8/93, yields 8.99% (1.668 US/DM)		Canada 5 5/8% 23/7/93, yields 6.63% (143.99 US/JY)		Sweden 9 3/8% 14/4/93, yields 13.3% (1.487 BP/US)
4 year	8.64%		CBA 14% 1/7/94, yields 14.06% (.6271 A\$/US)					
6 year	8.66%			Bk. of Nova Scotia 5 5/8% 7/5/92, yields 9.02% (1.6826 US/DM)				
8 year	8.68%				Australia 5% 30/10/98, yields 7.16% (1.2567 US/SF)			
Spot Exchange Rate	N/A	.5735	.7623	1.6495	1.4065	152.05	6.2605	1.6887

*For example, since a US\$-based investor would receive 457 basis points (1309-852) by holding the CIBC NZ\$ bond, the NZ\$ can depreciate to .528 NZ/US from the present spot exchange rate of

.5735 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.

FOREX RATES & UPDATE

<i>Currency</i>	<i>Spot</i>	<i>3-Month</i>	<i>12-Month</i>	<i>Comments vis à vis US\$</i>	<i>Comments vis à vis DM (Spot DM: 1.6485)</i>
Australian dollar	.7595-.7605	.7475-.7495	.7155-.7185	Neutral	Neutral
Belgian franc	34.07-34.12	34.15-34.30	34.24-34.69	Remain long	Neutral
Danish krone	6.2970-6.3020	6.3285-6.3405	6.4070-6.4295	Remain long	Remain long
Dutch guilder	1.8545-1.8555	1.8547-1.8562	1.8570-1.8590	Remain long	Neutral
Greek drachma	163.00-163.10	167.00-171.00	179.50-191.10	Remain short	Remain short
Hong Kong dollar	7.7855-7.7965	7.8060-7.8095	7.8580-7.8690	Neutral	Neutral
Irish punt	1.6245-1.6260	N/A	N/A	Remain long	Neutral
Italian lira	1212-1213	1223-1225	1254-1258	Remain long	Neutral
Kuwaiti dinar	.29070-.29090	.29060-.29100	.28960-.29100	Neutral	Neutral
Malaysian ringgit	2.7005-2.7015	2.6980-2.7015	2.6900-2.7100	Neutral	Neutral
New Zealand dollar	.5720-.5730	.5648-.5663	.5465-.5495	Neutral	Neutral
Norwegian krone	6.4090-6.4140	6.4565-6.4655	6.5690-6.6015	Remain long	Neutral
Portugese escudo	145.65-145.85	148.45-149.05	155.95-160.35	Neutral	Neutral
Saudi Arabian riyal	3.7500-3.7510	3.7470-3.7490	3.7410-3.7450	Remain short	Remain short
Singapore dollar	1.8535-1.8545	1.8540-1.8580	1.8450-1.8570	Neutral	Neutral
*Spanish peseta	120.90-103.00	104.40-104.60	108.70-109.00	Liquidate	Neutral
Swedish krona	6.0250-6.0300	6.0875-6.0970	6.2700-6.2900	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

Friday, April 6:

There are no changes or new recommendations. Next regular update Monday, April 9.

Monday, April 9:

There are no changes or new recommendations. Next regular update will be Thursday, April 12.

Thursday, April 12:

There are no changes or new recommendations. Next regular update will be Wednesday, April 18.

Wednesday, April 18:

There are no changes or new recommendations.

Friday, April 20:

There are no changes or new recommendations.

Flash Update, Wednesday, April 25, 10:30 a.m.:

Sell June Comex gold at market, placing initial stops at 384.00, close only.

Friday, April 27:

One new recommendation: As per our Flash Update on Wednesday, we recommended you sell June Comex gold at market, placing initial stops at 384.00, close only.

Tuesday, May 1:

There are no changes or new recommendations. Next regular update will be Friday, May 4.

Friday, May 4:

There are no changes or new recommendations.

Tuesday, May 8:

There are no changes or new recommendations.

Flash Update, Wednesday, May 9, 2:20 p.m.:

Cover immediately all short positions in crude oil. Also liquidate all long put options, taking substantial profits.

Flash Update, Friday, May 11, 9:30 a.m.:

Cover all short gold positions at market. There will be a regular update later this afternoon. Review of recommendations made this week: We covered all short positions in crude oil and liquidated all put options as per Flash Update Wednesday, May 9, 2:20 p.m.

We covered all short gold positions at market as per Flash Update Friday, May 11, 9:30 a.m. There are no other changes or new recommendations. Next regular update Tuesday, May 15.

Flash Update, Tuesday, May 15, 10:35 a.m.:

Sell long corn positions at market, accepting substantial profits. This will replace the regular Tuesday update if there are no new changes or recommendations.

Friday, May 18:

A review of this week's recommendations: We sold the July long corn positions at approximately 345* as per our Flash Update May 15, 10:35 a.m. There are no other changes or recommendations. Next regular update will be Tuesday, May 22.

*Should be 290. Will be corrected next Hotline Update.

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