

FRIEDBERG'S

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Red alert

With or without Quebec, the Canadian dollar has stopped falling. We have been friendly to it, as our readers know (and it still represents 20% of our preferred bond portfolio allocation) out of respect for the Bank and its Governor. Firm, coherent, and single-minded.

But the battle has just begun. And we don't mean Quebec. We mean Canada and its proposed, new constitution. Lurking beneath the news-making headlines is a danger far greater than separation. Our standard of living, nay, our very way of life is at stake.

Our colleague Neil Reynolds will take you first, behind the state, and then beneath the surface, where the true political agenda will be bared. Red alert.

At 10:30 p.m., Tuesday, July 7, the federal government and nine provinces announced tentative agreement of a comprehensive package of constitutional reforms. Two years earlier, on the collapse of the Meech Lake constitutional accord, Quebec Premier Robert Bourassa had asked: "What does English Canada want?" Here was the answer.

For the credit markets, the agreement itself was of more immediate importance than what was in it. On Wednesday, investors lowered the risk premium on Canadian government 10-year bonds by 12%, a one-day decline of unusual size. The spread between comparable Canadian and US bonds fell from 97 basis points to 85 basis points, a risk-reduction of \$1,200 a year on a million-dollar investment in Canada.

From the Plains of Abraham, though, emerged a distinctly reserved judgment. By July 17, Premier Robert Bourassa had unofficially consented to only an informal round of federal-provincial negotiations, and only provided everyone agrees to his list of preconditions. The markets tracked the mood swing precisely. By the same day, the markets had fully restored the pre-accord risk premium.

What was wrong with the July 7 accord? Why did Quebec not jump aboard? It was, after all, the only transportation in sight. The answer is not complicated. English Canada had offered Mr. Bourassa a lavishly remodelled coach on the train from which Quebec has always wanted off.

With only four or five weeks of boarding time left, one needs to appreciate the economic dynamic of Quebec's aspirations to understand what's happening, and why. Contrary to English Canada's operative assumption, language and culture are not Quebec's only concerns. Quebec stands alone because it alone is convinced Canadian federalism does not work economically. Quebec's Allaire Report, reflecting Mr. Bourassa's own judgment, listed the provinces objections at great length — the duplication of services, the multiple-jurisdiction entangle-

ments, the erratic monetary policy, the fiscal discord.

The July 7 accord, however, offered more of all these things. It is an important document whether it leads to an agreement with Quebec or whether it doesn't: Here is what English Canada wants. This is essentially what any agreement with Quebec will require; it is perhaps the shape of the Rest of Canada should Quebec go its own way. For the most part, it preserves federal spending powers within provincial jurisdictions, entrenches the present division of powers, and graciously concedes to the provinces only the jurisdictional prerogatives allotted to them 125 years ago by the British North America Act.

Further, it proposes a radical expansion of the federal government's obligation to spend money in Canada's poorer provinces. And it dismisses Ottawa's own agenda for a more perfect union, for a federalism without interprovincial trade barriers.

Further still, it proposes to monitor and regulate the New Canada with vastly more complex mechanisms of government. For Quebec, it wasn't only that Quebec's membership in an elected Senate would drop from 24 to eight. It was all of the nebulously defined federal-provincial tribunals; all

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Contributions by Albert D. Friedberg, Dr. Steve H. Hanke, David B. Rothberg, Neil Reynolds, Daniel A. Gordon, and Michael D. Hart.

Futures and options trading is speculative and involves risk of loss. Past trading results are not indicative of future profits.

of the anticipated resort to courts and quasi-courts, bureaucrats, and administrators.

Quebec wanted a streamlined, rapid-transit economic commuter train. The July 7 accord offered it a social welfare CPR.

What happens now? The accord is informal, unofficial, tentative, and doubt-full. For his October referendum, Mr. Bourassa needs a formal offer that is (1) binding upon the federal government and all of the provinces; and (2) politically acceptable in Quebec. He needs it within five weeks. For he is firmly constrained by Quebec's Bill 150, the law that specifies in precise detail "the process for determining the constitutional future of Quebec."

Bill 150 is categorical: The government "shall hold a referendum on the sovereignty of Quebec between October 12 and October 26, 1992." It sets September 9 as the final day to determine the wording of the referendum.

If Mr. Bourassa wishes to amend Bill 150, if he wishes to replace the referendum on sovereignty with a referendum on a "Canada option," he must present legislation to the National Assembly by the last week of August. This much is obligatory; in this, Mr. Bourassa has no wiggle room whatsoever.

Wisely or unwisely, Mr. Bourassa chose in drafting Bill 150 to legislate a restrictive format for negotiations; without an absolute deadline they might have gone on forever. Now his time-frame, as in a scene from a horror movie, is closing in on him. He cannot repeal or amend Bill 150 without a formal, binding offer; and without such an offer, he will be obliged to hold a referendum on sovereignty; and he will be politically compelled to support the "yes" position in it.

Patrick Monahan, a constitutional adviser to the Ontario government in the Meech Lake negotiations, has said that in enacting Bill 150, Mr. Bourassa "pulled the pin and then chained the hand grenade to his wrist." Bill 150 is still triggered to explode. For one way or another, with one set of wording or another, Quebec will vote on sovereignty within the next three months. Mr. Bourassa can survive only by making sure that whatever the Question, he is on the winning side.

By its nature, an accord of any kind is a comforting thing. When the credit markets relaxed on July 8, they reflected a civilized judgment that it is generally better to work things out than to blow them up. What is more interesting, however, is the relative complacency of the international markets to Canada's domestic conundrum. As risks go, 97 basis points isn't all that much alarm. In logical terms, this can mean only one thing: that the markets are relatively comfortable with either prospective result — either a hodge-podge of national compromise or some kind of equivocal assertion of Quebec sovereignty. (Quebec's commitment to use the Canadian dollar, come hell or high water, is presumably a significant source of comfort.) Prime Minister Brian Mulroney and Mr. Bourassa appear equally sanguine.

An accord acceptable to everyone is still hypothetically possible. (Mr. Mulroney could act unilaterally, present a compromise accord to the Commons, call a national referendum for the first week of September — and dare the provinces to oppose his last-chance, save Canada maneuver.) By any rational standard, though, an explosion of some kind must soon occur. Not to worry. Zen-like in their contemplation and composure, the markets appear to be telling us that no one is going to get badly hurt.

* * * * *

Only six months ago, Ontario Premier Bob Rae was saying that Canada needed to renegotiate "the very financial basis" of confederation. Only two months ago, he was saying that Ontario would never accept an elected Senate, with equal provincial representation, that held real power.

Yet Mr. Rae signed onto the July 7 accord enthusiastically. Why? The accord had met neither of his pre-negotiation requirements.

Mr. Rae, the social democrat, couldn't resist. The accord would confirm Canada as a union of welfare states. It would constitutionally impose upon the federal government a social democratic dynamic that (for all practical purposes) could never be amended or repealed. In short, his compromises had produced the deal of a socialist premier's lifetime — the commandments for a social welfare state, all of them chiselled on constitutional stone, all of them everlasting (which is more than one can predict for Mr. Rae's government).

Here are some big-spender obligations from the July 7 accord:

- In its proposals for "the economic and social union," the accord commits Canada to "ensuring sustainable and equitable development." This code phrase for central planning is not expressed as a goal (like "full employment") that can be loosely interpreted; rather as a constitutional obligation. As defined by the UN's Brundtland Report, sustainable development is "a discipline on consumption." It would require a mechanism to stabilize population, a mechanism to stabilize wealth and economic "through-put," and a mechanism to ensure the "fair" allocation of the country's "stock" of wealth among the population.
- Mechanisms for enforcement of this constitutional obligation would be crafted by the first ministers — suggesting that the provinces, rather than the federal government, would control the process. Note that the three socialist governments now represent more than 50% of Canada's population.
- The present constitution requires the federal government to "promote" equal opportunities and economic development throughout the country; and to provide equalization payments to the poorer provinces to ensure that "essential public services of reasonable quality" are provided for all Canadians. The accord significantly expands these obligations.

First, federal transfer payments would be provided in such amounts that all provinces would be able to maintain "reasonably comparable" levels of taxation. If the provinces are assured equality of public services and equality of taxes, regardless of provincial waste and inefficiency, only Ottawa would retain tax-rate elasticity; only Ottawa's tax rates could stretch.

Second, the territories would be included in these assurance.

Third, Ottawa, would be obliged — essentially on request, by any province — to fund regional development projects.

- The accord would grant "poorer province" status, and ensure federal transfer payments, to native governments. It would guarantee native peoples "essential public services at levels reasonably comparable to other Canadians in the vicinity." (This provision would be extended later to the Metis.) All natives would be eligible for transfer-payment protection, whether or not they live on reserves; three quarters of Canada's 750,000 native people don't. Although

no one knows where the money will come from, this provision alone will cost billions of dollars. One plan under consideration would tap the municipal tax base for the money to fund urban-dwelling natives.

- Canada's publicly-administered medicare program would be protected from any significant reform for all time; governments would be obliged to provide "high quality public education to all Canadians," perhaps raising a constitutional question mark over privately funded schools.
- The provinces would retain the authority to legislate self-protective trade barriers, limited only by a requirement that the restrictions not "unduly" impede the free movement of people, goods, and services.
- A number of federal-provincial tribunals would be established to monitor these economic and social commitments. The form and function of the tribunals would depend upon the nature of the various governments, the mandates given to them, and the individuals and staff provided for them. Yet the constitutional obligations would be absolute; the protection accorded to federal spending within the provinces would be more rigorous than the protection accorded to freedom of speech (which is subject to any infringement that can be legally defended as justifiable).

The imperative here is obvious. The six "poorer provinces" in English Canada went for the welfare payments; Alberta went for the elected Senate, its only real objective; and the two other "rich" provinces, Ontario and BC, loved the dominant socialist ideology.

Mr. Rae would have been smarter to have defended Ontario's economic interests. The province is essentially broke. It is now paying \$13 billion a year to Ottawa for welfare payments to the poorer provinces. It is \$100 billion in debt, and is now going to the markets with a mega-issue (on average \$1.2 billion) every month. It has made itself vulnerable to a liquidity crisis of its own. In its most recent rating on Ontario, DBRS said: "The Canadian capital markets do not have the liquidity to absorb this huge amount of debt; Ontario is therefore dependent on the foreign markets."

Worse, Ontario's huge annual deficits (\$10 billion a year) are for the most part structural. They reflect entrenched spending commitments. In a good-growth environment, they would decline only to \$6 billion or \$7 billion a year.

Worse still, Ontario is a "dis-saver" of remarkable proportion. When C.D. Howe Institute economist David Brown published his analysis of Ontario's savings-investment ratios last month, he called his finding "truly amazing." Forget for a moment Ontario's net loss through the maze of federal-provincial spending programs. Within private sector decision-making, Ontario is a net "dis-saver" equal to 6% of its GDP. In recession year 1982, the gap was \$20 billion; in boom year 1989, the gap was still \$8.5 billion.

There is no reason why the investment made in a particular region should always equal the savings in that region. In a free-market economy, investment will move to the locations where it will be most productively used and where it will produce the best returns. The ratio, though, is useful; and especially when it holds, as it has, for 20 years. It helps to explain Ontario's discouraging record in productivity gains, the only way to increase wealth. Further, a significant portion of Ontario investment has been wasted. Ontario Hydro, for example, is a scandalously unproductive and inefficient

enterprise; it is \$33 billion in the hole and is still increasing its debt at the rate of 10% a year.

In the last two years, Ontario — and the rest of Canada, too — has sent record amounts of capital across the border. Queen's University economist Thomas Courchene says that the most pressing economic question for Ontario is: When will the outward movement of its wealth become a migration? He suggests that Ontario will soon be compelled to join Quebec in seeking a more streamlined and more decentralized economy. He suggests also that Canada will be compelled to stop subsidizing "place" ahead of "person."

For at the other end of the wealth scale is Newfoundland, recipient of enough money each year in federal transfer payments to give each household \$17,000, recipient of billions of dollars in "regional development" projects. What has this investment in sharing accomplished? The Economic Council of Canada observed that Newfoundland collects more money in cigarette taxes than it does in mineral taxes — although richly endowed with base metals; that it collects more money from the registration of deeds that it does from its vast forests.

It's an expensive way to keep people down on the farm. Entrenched in a constitution, the practices could kill off the country all by themselves — a strange way to save a nation.

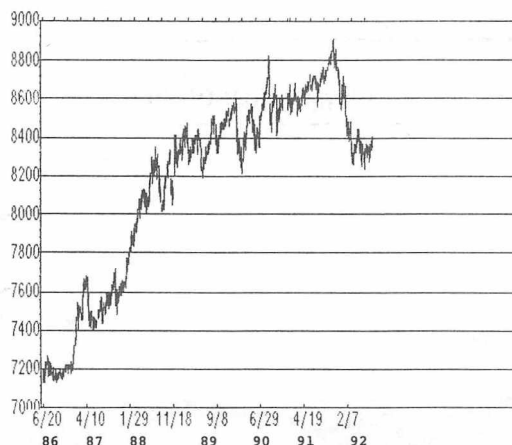
People have started calling the July 7 accord the "Pearson accord," after the external affairs building in which the talks were held. The name seems inappropriate. More properly we should call it the "anglo accord." Or, more appropriately, the last spike.

— Neil Reynolds

STRATEGY: *The Canadian dollar has formed a significant bottom. The theme is well known: heavy and regular provincial offshore borrowings coupled with a super-disciplined monetarist approach provide a firm foundation for the nominal value of the currency. At the same time, the Canadian unit has depreciated, in real terms, over 5.3%, since last year at this time, a product of a 3.3% nominal decline and, at least, a two percentage point inflation gap in its favor. That makes it relatively cheap.*

We are stopped out of our long futures positions, but we'll persevere. Buy December '92 at market, placing initial stops at 8200, close only.

Chart 1 — CME Can. Dollars



GOLD

When do you accept profits?

Last month, with nearby gold trading at \$342/oz., we commented that "the strange quiet that descended over the bullion markets may presage some upside fireworks" and went about confirming our buy recommendation.

Is this all we're going to get? The deeper question, of course, is, Have we entered a bull market? The answers: pretty close and probably not.

What *are* the bullish arguments? First and foremost, the pathetic lack of investor interest at the recent lows attested by low volume, low open interest, narrow price ranges, low consensus, and absurdly low option volatility premiums. With the recent advance, *some* of these signs have begun to change — principally open interest, which has risen over 20% in the short span of two weeks, and bullish consensus, which has moved up to an average of 80%.

Amazingly enough, and despite the largest advance in seven months, gold has enjoyed precious little or no "headline" coverage. We are also puzzled by the persistence of extremely low readings in implied volatilities. Finally, with the exception of a few trading days, daily ranges have remained "tight" — hardly a sign of distribution.

The net result of this analysis is that *technically* the advance does not appear exhausted. What is more, the 20,000-plus increase in open interest, which we assume to represent hedge selling, could turn into a bullish factor should the

advance look more "serious." Mining companies, bullish in their hearts, are not about to allow themselves to be left behind: Short-covering could spark the terminal phase of the run-up.

Other, but less important, bullish factors are labor unrest and political uncertainty in South Africa (a major strike is due on August 3) and the increased probability of a second Gulf military confrontation.

None of these factors (including the technical one) is likely to propel gold into a bull market phase. Only a peak and then a fall in production (not yet in sight) that fails to meet anticipated increases in usage plus investment demand can do it. And this does not seem to be, as yet, in the cards.

A further note of interest: Note the "weak" return of the rally when expressed in hard currencies, DM and yen (see Charts 3, 4). Hardly a ripple. And note the more vigorous but still not significant rally against the CRB (Chart 5), a commodity index. Gold is partly a foreign exchange asset and partly a commodity. This dual character explains its simultaneous strength (against a falling dollar and against falling commodity prices) and weakness (against hard currency).

STRATEGY: For now, we should content ourselves with bear market rallies. The trick is knowing when to get out. Stay tuned, and in the meantime raise stops to 354, basis October '92, close only.

Chart 3 – GOLD/DM

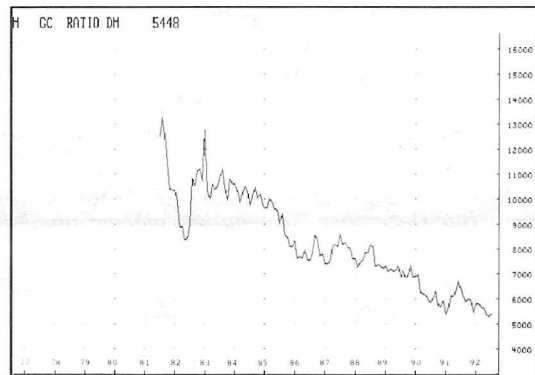


Chart 4 – GOLD/¥

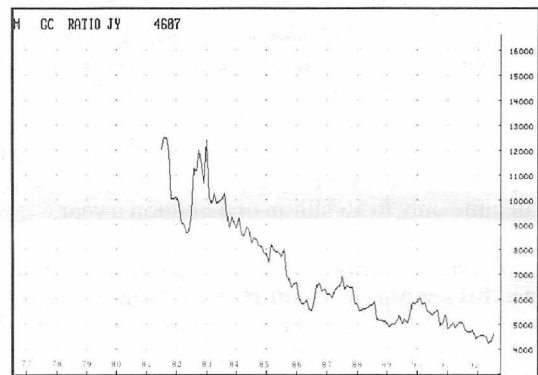


Chart 5 – GOLD/CRB

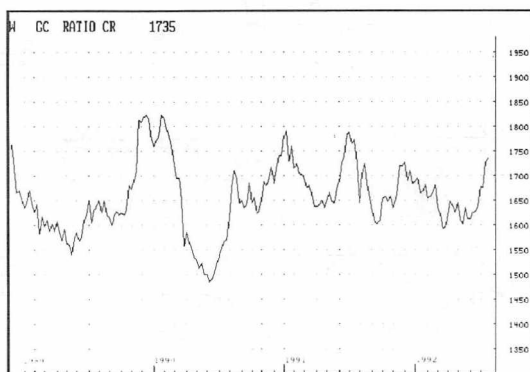
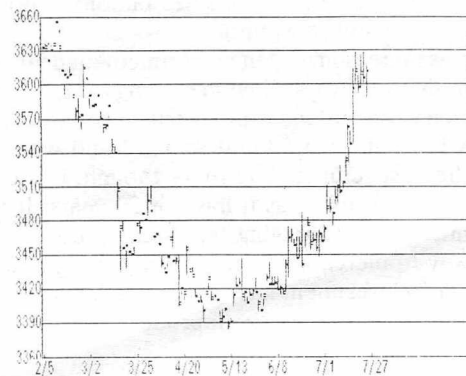


Chart 6 – COMEX GOLD OCT '92



DEUTSCHEMARKS/EUROMARKS

Waiting for the other shoe to drop

As we had been expecting for quite some months, the "Bubba" moved to raise, if only symbolically, the discount rates by 3/4 of a point.

The Bundesbank reaffirmed its money supply targets and left the door open for a real increase in rates (via the Lombard rate) in the not-too-distant future.

Intense pressure from other EMS members against further raising rates may suggest an alternative route to solving Germany's inflation problem: a 5% to 7% revaluation in a general EMS realignment, later this fall. The revaluation should lower import costs and force the export side to be more competitive, reverberating in a lower consumer price inflation rate. By itself, this solution carries a low probability given the Bundesbank's monetarist bent. It could, however, come in a *package* of higher rates, so as to make the increase more palatable to its partners. If so, the DM/punt and the DM/Sterling cross rates could make for interesting speculations.

Concerted central bank intervention at around the 14475-14500 level was sufficient to cool off the dollar-bashing party in what increasingly looked like a bandwagon effect. In past issues we have described these speculative moves at great length and have suggested that firm and concerted intervention could be sufficient to maintain exchange rates within broad ranges. Should pressure persist, central banks may have to resort to a narrowing of interest rate differen-

tials. Easier said than done. The Fed is not likely to raise rates in the face of continued economic sluggishness just prior to an election. And the "Bubba" has still some tightening to do.

Other factors, however, may still come into play to help central banks in their predicament.

First, the quick economic and social disintegration of the former Soviet Union, so aptly described by our colleague Steve Hanke (see "Russia," Page 6), may change sentiment, at least short term, towards Germany and the rest of Western Europe.

Second, the Yugoslavian civil war seems to be spreading, and again it may temporarily sour sentiment towards the European currencies.

Finally, it may just be possible that the US recovery emits a few more signs of life — bringing back the early 1991 "convergence play."

Why are we looking for a change in trend? Because the bearish consensus on the dollar has become too one-sided, too overwhelming and...too obvious. Markets never reward stale stories.

STRATEGY: *We liquidated our long European currencies and accepted handsome profits (see Hotline Update for July 2). Stand aside. We remain short Euro-DM futures and long puts. We are showing large gains in the trade, but we are patient. There's more to come.*

Chart 7
CME Deutsche Mark Sep '92

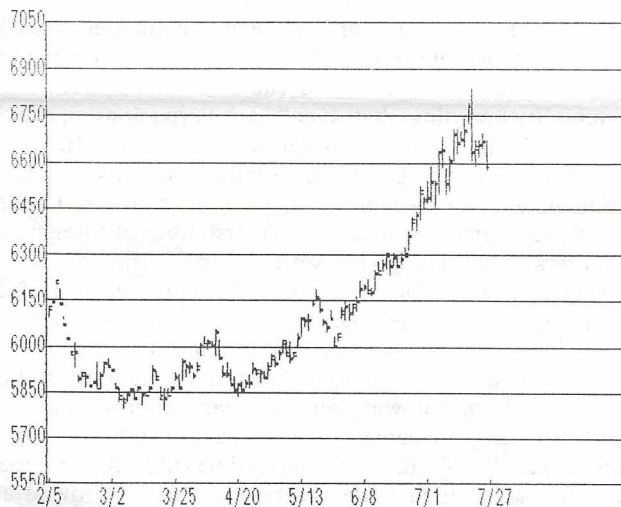
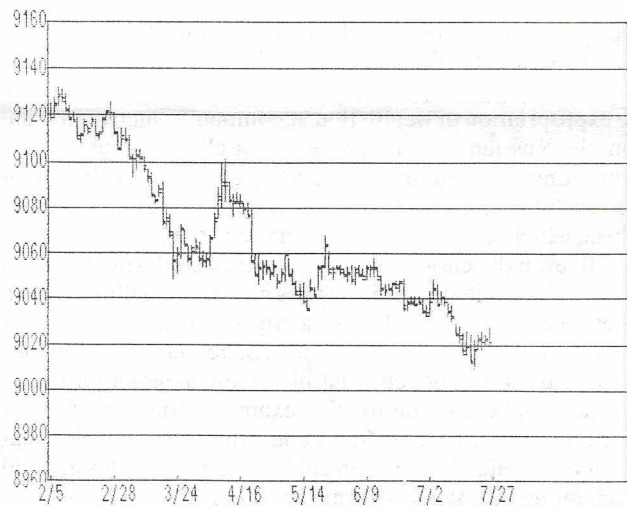


Chart 8
LIF Short Euromark Sep '92



JAPANESE YEN

Going south

A collapsing economy and an overly tight monetary posture have convinced Governor Mieno to lower (as of tonight) the official discount rates by half a percentage point.

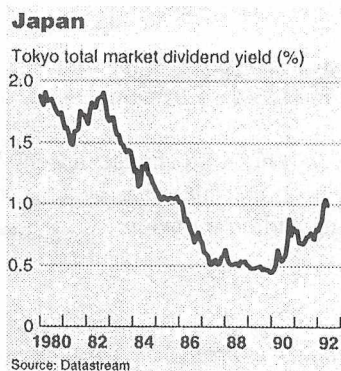
Anticipating this easing, the yen had been weakening, as we had been expecting, against the DM, with the DM/yen cross reaching 85.10.

Despite the fall in rates, the bursting of the bubble is proceeding apace. Stock prices made fresh five-year lows.

They are likely to find bottom only after dividend yields become more reasonable (see Chart 9). At 1.1% they are well below the 2.9% world average and absurdly lower than the 5.3% yield on government bonds. Fair value must be south of Nikkei 8000.

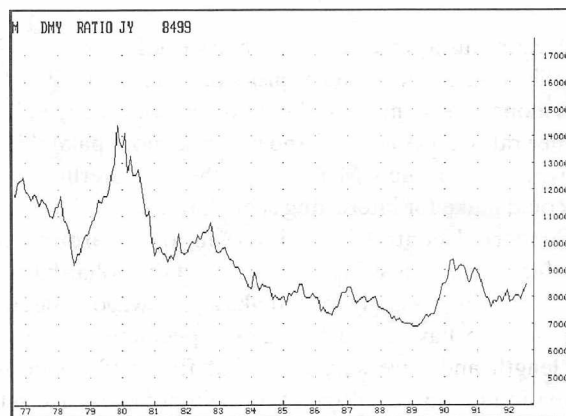
STRATEGY: *Remain short yen versus long DM. Remain short Nikkei futures.*

Chart 9



Courtesy: Financial Times, London

Chart 10 - DM/JY



RUSSIA

The coming ruble Chernobyl

With each passing month, the price level in Russia rises by 20%. At that rate, the ruble's half life is three months, and after a year only 7 kopeks of each ruble remains. To facilitate the expropriation of wealth that accompanies such high inflation, the Russian government does not allow the ruble to be freely converted into foreign currencies. That restriction on convertibility amounts to little more than a ring fence around rubles, which are a rapidly depreciating asset.

To even the casual observer, the ruble is dysfunctioning. Indeed, the ruble does not possess any of the hallmarks of a functioning currency. It fails to serve as a satisfactory store of value, medium of exchange, or unit of account. That failure has serious consequences that block any meaningful transition to a market economy. For example, Russians save by hoarding bricks, timber, food, and other commodities that retain their value better than rubles and ruble-denominated financial assets. While commodity hoarding is rational for Russians, it is costly because hoarded commodities are diverted from current consumption and production.

Russians also save by obtaining "greenbacks" and other "hard currencies" that have much longer half lives than the ruble. Indeed, when possible, they participate in the black

market with a vengeance, and consequently the real value of hard currencies held by Russians is two to three times greater than the real value of all the rubles in circulation. Like commodity hoarding, that so-called dollarization imposes a cost. To obtain dollars and other hard currencies, Russians must exchange real goods and services for bits of paper produced by Western central banks at almost no cost. Consequently, dollarization creates a perverse form of foreign aid that flows from Russia to the West.

The inconvertible ruble also fails to provide a satisfactory means of exchange. The outside world's refusal to accept the ruble impedes much-needed Western investment in Russia. Indeed, just when Russia needs Western capital inflows, hot money is illegally flowing out to escape expropriation by inflation. Last year capital flight amounted to between \$14 billion and \$19 billion. The inconvertible ruble also impedes foreign trade, which is desperately needed to provide an element of competition in what might be the world's most monopolized economy.

The ruble is not even a good medium of exchange within Russia and other republics in the so-called ruble zone. As any Western tourist knows, Russians usually refuse to part with

their wares for anything but greenbacks. For Russians doing business among themselves, barter is almost as common for transactions inside Russia as it is in the sphere of Russian international trade. This increases transaction costs and precludes commodities used to facilitate exchange from being used in consumption and production.

Since the ruble is not a reliable unit of account, it is difficult to make accounting calculations, to write contracts, and to make meaningful business decisions in Russia. Without a reliable measuring rod, the means of efficient communication through market prices becomes exceedingly difficult. Indeed, in their attempt to set "realistic" prices in rubles, about all the Russians can do is observe the dollar price of an item, then obtain the ruble-dollar exchange rate on the black market, and then employ that rate to set a ruble price. This procedure is awkward and has its limits. After all, dollar prices for many goods and services aren't really available, particularly in the vast hinterlands of Russia.

By any standard, Russia's inflation of 20% is high, and the ruble is dysfunctioning. But, hold on to your hat, all indicators point to a coming ruble Chernobyl. By the end of this year, the monthly inflation rate should reach the hyperinflation threshold of 50% per month. At that rate, a ruble's half life is one month, and within six months, it is worth less than a kopek. The coming ruble debacle will create significant economic instability and leave many political casualties in its wake.

To understand why a ruble Chernobyl is in the cards, we must look no further than the state of Russian industry and its connection to that country's credit system — particularly the central bank, which serves as the economy's ultimate credit pump. Russian industry is made up of a collection of huge state-owned enterprises (SOEs). At least 80% of these are insolvent. They require a massive shakeout and restructuring. However, that has not been forthcoming.

To keep their industrial dinosaurs afloat, the Russians must create a sea of credit. Not surprisingly, we observe the creation of just such a credit sea. To avoid cutting output and firing workers, the SOEs have taken to supplying each other with interest-free credits. These so-called inter-enterprise credits have been piling up at an unbelievably rapid rate, and the total now exceeds all the rubles in circulation.

In addition, the SOEs have set up commercial banks. Indeed, 80% of the 2,000 commercial banks in Russia have been founded by SOEs. The banks' primary purpose is to extend cheap credit (interest rates charged are less than inflation, so real interest costs are negative) to their founders.

The SOEs also obtain subsidies and credits directly from the Russian government. That explains the government's ballooning budget deficit.

If that weren't enough, although unable to print ruble notes, the central banks in the republics of the former Soviet Union can issue ruble credits, and they have been doing so, particularly the Ukraine. At the end of the day, all issuers of credit must knock on the Russian central bank's door and request a ruble bailout. They must sing the same song: "Give us rubles or we'll go broke." That tune is already being heard, and it explains why the "tight-fisted" Mr. Georgy Matiukhin was forced to resign as chairman of the Russian central bank in July.

* * * * *

Contrary to claims being made in Moscow and by members of the international chattering classes, the Russian central bank will not be able to avert a ruble Chernobyl. Moreover, the central bank will have great difficulty producing a sound, convertible ruble after the ruble meltdown.

To appreciate that harsh judgment, consider that a central bank must possess credibility before it can issue a sound, convertible currency. Understandably, that credibility does not exist in Russia. There has been a government issue of currency since 1768. However, Russia's currency was fully convertible for only 35 of those 224 years, with the last year of unimpeded convertibility being 1914.

If that record isn't enough to tarnish the central bank's reputation, its recent behavior has been. In early 1991, 50 and 100 ruble notes were demonetized. Although most people were able to exchange their 50 and 100 ruble notes for an equivalent amount of smaller denominated rubles, some 10 billion to 12 billion rubles were confiscated by officials who determined that the notes had been obtained through "speculation" and other illegal means.

Since then, the government has announced various schemes to prop up the ruble. However, none has been implemented. Add to that the coming ruble Chernobyl and the fact that Russians have very little faith in any government institution, and it is hard to imagine that the central bank will be able to establish the level of credibility required to issue sound money.

Many persons believe that since Russia has joined the International Monetary Fund (IMF), the credibility problem will be solved. That is a false hope. To appreciate that, let's look at Yugoslavia, which has been a member of the IMF since 1945. The experience of Yugoslavia shows that in an economy that has many similarities to that of Russia, responsible behavior, credibility, and sound money have proved as elusive as the Holy Grail.

In December 1989 the monthly inflation rate was 50% in Yugoslavia, and for the entire year it had been 2,720%. Armed with an IMF stabilization plan, Yugoslavia introduced currency reform in December 1989. It established a "hard" pegged exchange rate of seven dinars per German mark. To maintain the peg under conditions of low credibility, real (excluding inflation) lending rates had to be pushed up to about 40% per year during most of 1990.

Although inflation came down in Yugoslavia during 1990, the rate remained much higher than in Germany. Hence, the dinar became grossly overvalued *vis à vis* the German mark, and the Yugoslav economy slumped into a deep depression.

Eventually Yugoslavia had to give up on the hard peg and pump massive amounts of credit into its industrial dinosaurs and the commercial banks that those enterprises owned. Now the official exchange rate is 1,200 dinars per mark, while on the black market it is about 1,500 dinars per mark. The government in Belgrade claims that inflation may climb to 100,000% or more on an annualized basis by the end of 1992.

STRATEGY: *The fallout of the ruble Chernobyl could have a serious negative impact on Western Europe. Hyperinflation may lead to political and military anarchy, the equivalent of a loose cannon. DM bulls should at all times be aware that instability is only a few miles away.*

— Dr. Steve H. Hanke

S&P 500

Too many bears

Last month we wrote the following:

"The eve of the release of second-quarter earnings is as good a time as any to test this market: Logic dictates a weakening of stock prices *into* July 7 (the earliest date on which reports begin to flow) and *just past* that date (July 10-12). The critical period for *assessing* medium-term market direction will be July 7 to July 10.

"While the market *could* begin dropping earlier (it usually does, as analysts receive more up-to-date information on the upcoming reports and they are determined to be disappointing), it *need* not do so. But regardless of its near-term direction, if it rises or even holds firm during the critical period, it will continue to rise or hold steady for a *number* of *months*. If, on the other hand, it is weak during the critical period, it may signal the beginning of a bear market."

July 7-10 is history and stock prices have refused to break. The Nikkei and European bourses have been falling, registering in some case *multi-year* lows (Italy, Norway,

Japan), and yet New York opens lower and recovers towards the close.

Sentiment is *too bearish*, a factor we already noted last month. For example, out-of-the-money puts are trading at large multiples of the price for comparable out-of-the money calls. Similarly, the bullish consensus has averaged 23.1% for the past eight weeks; it has been below 25% for five consecutive weeks — the largest cluster of positive readings since the second half of 1990.

Fears of a third dip are rampant, though we believe unfounded. The economy is likely to continue to grow, albeit at a very reduced pace, weighted down by the great unwinding of corporate and household debt.

Our nose tells us that the S&P 500's next major move (-/+ 10%) is up, not down. There is just too much pessimism.

STRATEGY: *You are flat, as per Hotline Update of July 10.*

COMMODITIES

Soybeans

In the last several weeks, grains and oilseeds have collapsed. Corn, wheat, and beans have all made new contract lows. Traders say: "It's over."

They are partially right. What is over is the rash of predictions of a drought this summer. In the wake of a weather pattern that has been the sorry opposite, opinions of a hot dry summer have become about as popular as conspicuous consumption.

The question now is: Does a wholesale stampede of disappointed bulls predict bear markets?

I doubt it. In fact while I wouldn't go quite so far as to predict major bull markets, I would suggest there is decent opportunity in the rout currently taking place. The opportunity seems biggest in soybeans.

Soybean stocks on hand June 1 stood at 696 million bushels. With about six weeks left in the current 1991-92 marketing season, year-end stocks can reliably be predicted to come in at 300 million bushels. This is a somewhat smaller stock count than was on hand in September 1991 and somewhat larger than the count at the end of the 1990 and 1989 crop years. The number may be characterized as leaning to the bullish side of neutral. It is definitely not bearish.

Re: acreage: Based on its early June survey, the USDA estimates 59.03 million acres have been planted this year. The USDA's June estimate compares almost exactly with actual plantings in 1991. However, since the estimate was by

1.6 million acres larger than the expectations created by the lower estimate made by the department in March, it was taken very badly by the already frightened bulls.

Overlooked in their flight was the fact that last year's June USDA estimate was larger than the estimate the department made last March. And last year its final acreage report was smaller than its June estimate. In fact, in seven of the past eight years, the final USDA report on planted acreage came in lower than the department's June estimate.

Which brings us back to the weather. Since 1985 (but not including the drought year of 1988), soybean yields have ranged between 32.3 and 34.3 bushels per acre. These yields have been consistently high. As we've said, grain markets have collapsed as rains have fallen in excess of, rather than beneath, the hopes of the bulls; the reasoning having been that only a drought could reduce the yields. Again overlooked has been that soybeans have not yet entered their pollination stage, the critical phase in plant development. That stage is just scheduled to begin this week.

The weather has not been hot and dry. However it has been unusual. It is possible the weather could still turn hot and dry. It is more likely the weather could turn even cooler and wetter than it has been. Cooler, wetter weather would be just as bad for beans as drought; in the consistently high-yield years of 1985 through 1991, there wasn't a single year when the weather was as cool as it's been so far in 1992.

In the final analysis of yields, I agree with the Extension Specialist at the University of Illinois who predicts that they

are more likely to come in at the lower rather than the higher end of the range of expectations. And therefore final production figures are likely to prove disappointing.

Production figures that come in less than expected should put a nice little jolt into a commodity grown only to feed animals, a good percentage of the population of which (hogs) are increasing in number at a rate 5% higher than last year.

To summarize the entire fundamental picture: It is extremely unlikely stocks at the beginning of next September will be any larger than they will be at the end of this September. It is more likely they will be smaller. And there is still a weather-related chance the stocks will be much smaller.

Which brings us to price: The cash price of beans has averaged \$5.72 so far this marketing year. During the whole 1991-92 marketing year to date, prices never got below \$5.50. We are already below the average and descending rapidly toward the lows. We understand (from noticing that the open interest has declined by nearly 20% from its high point) that the current downmove has come about as a result of massive liquidation and in defiance of fundamentals.

It is possible we are approaching lows we may not see again at least until next March when the 1993-94 crops is planted.

If these are the lows, there's an awful lot of upside ahead. Last year prices ranged 92¢. The range was the lowest since 1975. Any application of standard deviation to the ranges of prices since 1975 would lead to the conclusion that \$7.00 beans sometime within the next 12 months is not unlikely.

STRATEGY: *Conservative traders should be buyers of November 575 calls and sellers of 650 calls. The less conservative should buy the 575 calls while selling November 525 puts. In either case the opportunity is seized cheaply.*

Cocoa

The cocoa market has risen in response to reports of ongoing dry weather in West Africa, a strike in Ghana, and an absence of origin selling. It is notable that the sharp rise has occurred despite the failure of official discussions amongst producers to agree on price-stabilizing methods.

It seems we may have found a bottom to cocoa. However, before we get carried away with the notion of an express trip to \$1,400, we must point out that as we understand it, Ivory Coast has still got 50,000 tonnes of its current year's sales quota to meet. It is our opinion that until that quota has been fulfilled, we should expect the market to stall and/or to suffer sharp setbacks.

STRATEGY: *We advise covering the December 800 puts which we sold last month at \$26 at the current \$8. At this point we shall remain comfortably long the 1100 calls for which we've effectively paid next to nothing.*

Sugar

I met the assistant to the minister of sugar in Havana last month. He said he'd try to arrange a meeting with his boss. When I was phoned at my hotel a few days later the connection was bad, I couldn't speak Spanish adequately, and my interpreter friend wasn't around. In summary, I learned nothing about the state of the critical Cuban crop.

I did, however, learn that poverty does not necessarily breed indignity; the beleaguered Cubans have virtually nothing except a sense of self-respect I've never seen amongst people so bereft.

STRATEGY: *Despite having lightened my position considerably as per last month's advice, I'm still long a little bit of sugar via October calls.*

— David B. Rothberg

LDC COMMENTS

Argentina: Act II

Midway through his presidential term, Carlos Menem began to flirt with the idea of a second term (past 1995). It required a constitutional change, and that's when the problems began.

In the horse trading that ensued, Menem's government began to compromise on some serious yet-to-be-implemented reforms: private social security (modelled on the highly successful Chilean model), labor deregulation, tax rationalization; and so on.

Sensing official weakness, private and public interest groups began to demand "adjustments." The spectacular liberalization program carried out to date was in danger of collapse.

Fortunately, Finance Super-Minister Domingo Cavallo prevailed on the president to distance himself from the pernicious campaign to amend the Constitution and reaffirm his commitment to deepen his free market reform. Menem stated that he wanted to "open this new stage with grandeur, without thinking of future ambitions, without hegemonic tempta-

tion, without delirious dreams of perpetuation."

In the meantime, the heady growth of the past year has begun to slow down, reined in by foreign competition (via rising imports), rising wage demands, some capacity bottlenecks that have begun to appear in the decapitalized industrial sector, and the violent real appreciation of the peso *vis à vis* the dollar that has been occurring over the past few months.

Argentina's convertibility scheme and its fixed parity of 1 peso to US\$1.00 is not in danger. The money supply is still backed by over 94% of reserve holdings of US dollars with the balance being represented by Bonex (dollar) bonds marked to market.

There are, however, a number of uncertainties and issues that will have to be monitored closely in coming months. Will Menem carry out Act II (which includes a number of mega-privatizations and the shedding of still more labor in the public sector) in the face of a possible recession? Will the

government ignore the pleas of the export sector, crushed by the peso's real revaluation? Will it ignore academics who point alarmingly at the domestic shrinkage of the trade surplus (to perhaps less than \$500 million from \$4 billion in 1991 and more than \$8 billion in 1990) just at a time when the federal government has had to increase its resource transfer abroad to service the foreign debt?

Argentina's foreign exchange regime necessitates a balanced fiscal sector. Thus far the government has managed to post monthly fiscal surpluses, in part thanks to privatization, in part better collection procedures, and in great part to increased taxes. Given the increased debt-service requirements, produced by the Brady debt renegotiations, the chaotic state of provincial finances (which revert back to the federal government), and the slowdown in tax revenues, one wonders how much fiscal pressure the economy can withstand, should tax increases again be chosen as the balancing route. And therein lies the risk to the convertibility scheme.

Act I was relatively easy: It was a product of *necessity*. Act II requires courage, vision, and a firm and coherent implementation. A casual observer, in witnessing the recent

40% crash in stock prices, may come to believe that the play is over. We rather think of it as an intermission, where in good *porteño* style, we order a *trago* of bitter *mate*.

The Bic V continues to be an excellent investment, yielding in local pesos (equal to US dollars) approximately 20% per annum. Care must be exercised in further purchases, as the premium over par hovers around 4%: The principal risk, *at this time*, is that the government calls for early redemption of the entire issue at par.

Recommended bond portfolio allocation for new portfolios

For new portfolios, we recommend the following investments:

Danish krone	45%
US dollar high-yield convertible bonds	20%
Canadian dollar bonds	20%
Argentina BICV	15%

**Chart 11
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\$, DM, SF, DKr, BP, FFr, ECU, CD, SAR, ARG) or revalue JY before the interest rate advantage/disadvantage is overcome by currency depreciation/appreciation. **Rates as of July 23, 1993.**

	US \$	NEW ZEALAND \$	AUSTRALIAN \$	DEUTSCHEMARK	SWISS FRANC	JAPANESE YEN	DANISH KRONE	BRITISH POUND	FRENCH FRANC	EUROPEAN CURRENCY UNIT	CANADIAN DOLLAR	SOUTH AFRICAN RAND**	ARGENTINEAN PESO
1 year	3.47%	Tourist Hotel '93 yields 6.23% (.5348 NZ/US)		EIB of '93 yields 7.22% (1.5367 US/DM)		Canada '93 yields 4.02% (127.22 US/¥)	Denmark 93. yields 9.75% (6.059 Dkr/US)					ESCOM '93 yields 13.34% (.2312 US/SAR)	
2 year	4.17%		CBA, '94, yields 6.04% (.7221 A\$/US)										
3 year	4.61%												
4 year	5.10%			*Bk. of Nova Scotia yields 8.50% (1.6845 US/DM)				Sweden '96 yields 8.93% (1.6767 BP/US)	Credit Lyonnaise '96 yields 9.30% (5.857 Ffr/US)				
5 year	5.60%			World Bank '97 yields 7.83% (1.6465 US/DM)							Eksporthans '97 yields 7.07% (1.275 US/CD)		
6 year	5.90%				Australia '98, yields 6.81% (1.3847 US/SF)								
9 year	6.58%									U.K. 2001 yields 9.27% (1.0983 ECU/US)			BIC V '01 yields 20.32% (.3324 \$/ARG)
Spot Exchange Rate	N/A	.5491	.7483	1.4830	1.3155	126.55	5.7130	1.9160	5.0070	1.3745	1.1895	.2532	.990

*For example, since a US\$-based investor would receive 340 basis points (850-510) by holding the Bank of Nova Scotia DM bond, the DM can depreciate to 1.6845 US/DM from the present spot exchange rate of

1.483 US/DM over the next 5 years for the DM investment to break even with current US\$ rates of interest. Assumes that bonds are held to maturity, and coupons are reinvested.

**NOTE: These bonds pay interest in commercial rand, which presently trades at a premium to the financial rand used for this table.

FRIEDBERG CAPITAL MARKETS

Chart 12 – Foreign Currency Bonds

Date: July 23, 1992

WE OFFER THE FOLLOWING BONDS SUBJECT TO CHANGE WITHOUT PRIOR NOTICE:
MINIMUM US\$5,000 (CDN.\$7,000)

ISSUER/MATURITY DATE/COUPON	BID	OFFER	CURR.ANN. YLD.TO MTY.	NEXT PAYMENT DATE
DEUTSCHE MARK DENOMINATED				
KINGDOM OF SWEDEN 7 1/4% 1/2/95 call @ 100 1/2 in /93	96.55	97.30	8.46%	Feb.01
EUROPEAN INV. BANK 5 1/2% 9/08/93	97.60	98.35	7.22%	Aug.08
BANK OF NOVA SCOTIA 5 5/8% 07/05/96 RRSP eligible	90½	91	8.50%	May 07
WORLD BANK 5 7/8% 4/02/97 RRSP eligible	92	92 3/4	7.83%	Feb.04
SWISS FRANC DENOMINATED BONDS				
GOVT. OF AUSTRALIA 5% 30/10/98	88	91	6.81%	Oct.30
DANISH KRONE DENOMINATED BONDS				
KINGDOM OF DENMARK 8% 20/08/93	97.55	98.30	9.75%	Aug.20
ECU DENOMINATED BONDS				
UNITED KINGDOM 9 1/8% 21/02/01	98.35	99.10	9.27%	Feb.21
BRITISH POUND DENOMINATED BONDS				
KGDM OF SWEDEN 9 3/8% 14/04/93	99½			Apr.14
KGDM OF SWEDEN 8 3/4% 29/5/96	98 5/8	99 3/8	8.93%	May 29
FRENCH FRANC DENOMINATED BONDS				
CREDIT LYONNAISE 9 1/2% 23/12/96	99.85	100.60	9.30%	Dec.23
JAPANESE YEN DENOMINATED BONDS				
GOVT. OF CANADA 23/7/93 5 5/8% RRSP eligible	100.80	101.50	4.02%	Jul.23
CANADIAN DOLLAR DENOMINATED BONDS				
ONTARIO HYDRO 10 7/8% 08/01/96 (semi annual)	112 5/8	113 3/8	6.58%	Jul.08
EKSPORT FINANS 7 3/4% 5/11/97	101 1/8	102 7/8	7.07%	Nov.05
NEW ZEALAND DOLLAR DENOMINATED BONDS				
TOURIST HOTEL 0% 04/06/93	94	95	6.23%	4/6/93
SOUTH AFRICAN RAND DENOMINATED BONDS				
ESCOM 11% 31/10/93 (semi)	97.05	97.80	13.34%	Oct.30
AUSTRALIAN DOLLAR DENOMINATED BONDS				
COMMONWEALTH BANK OF AUSTRALIA 01/07/94 14%	113	114	6.04%	Jul.07
ARGENTINEAN PESO DENOMINATED BONDS				
ARGENTINA BIC V FIXED/FLOATING 1/05/2001 callable in full on any interest date	92.28	93.03	20.32%IRR	4th day of mth.
U.S. DOLLAR DENOMINATED FIXED CONV.BONDS				
COOPER CO'S 10 5/8% 01/03/05 (semi) CV @\$27.45 p/sh callable in 1995	86½	87½	13.03%	Sep.01
DICEON ELECTRONICS 5 1/2% 1/3/12 (semi) CV @\$39.50 p/sh	30	33	18.76%	Sep.01
BURNUP & SIMS 12% 15/11/00 (semi) CV @\$16.79 p/sh	77½	79½	17.32%	Nov.15
U.S. DOLLAR DENOMINATED FIXED RATE BONDS				
FARM CREDIT CORP. 7 3/4% 10/06/96 RRSP eligible	107½	108	5.39%	Jun.10
REPUBLIC OF ARGENTINA 7/10/93 11% (semi) 1 yr. put	103 7/8	104 5/8	6.76%	Oct.07
U.S. DOLLAR DENOMINATED FLOATING RATE NOTES				
UNITED KINGDOM 24/09/96 3 mo.LIBID-1/8 (qtly)*callable @ 100	99.95	100.25	3 11/16%	Sep.30
REPUBLIC OF ITALY 30/04/93 3 mo Limean (qtly)	99.70	100.10	4 1/16%	Oct.31

Although we monitor these issues specifically, we also can fill any order in any foreign bond.

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

FOREX RATES & UPDATE

<u>Currency</u>	<u>Spot</u>	<u>3-Month</u>	<u>12-Month</u>	<u>Comments vis à vis US\$</u>	<u>Comments vis à vis DM (Spot DM: 1.4980)</u>
Australian dollar	.7464-.7469	.7426-.7433	.7346-.7366	Remain short	Remain short
Belgian franc	30.58-30.62	31.04-31.11	32.28-32.42	Neutral*	Neutral
Danish kroner	5.7450-5.7500	5.8545-5.8655	6.1235-6.1460	Neutral*	Remain short
Dutch guilder	1.6770-1.6780	1.7029-1.7044	1.7723-1.7748	Neutral*	Neutral
Finnish markka	4.1000-4.1050	4.2035-4.2155	4.4880-4.5130	Neutral*	Remain short
Greek drachma	182.75-182.85	189.75-191.65	211.25-216.35	Neutral*	Neutral
Hong Kong dollar	7.7360-7.7370	7.7290-7.7330	7.7300-7.7400	Neutral	Neutral
Irish punt	1.7960-1.7980	1.7620-1.7700	1.6850-1.6950	Neutral*	Neutral
Italian lira	1130-1131	1163-1167	1250-1261	Neutral*	Neutral
Malaysian ringgit	2.5005-2.5015	2.5155-2.5365	2.5505-2.6315	Neutral	Neutral
New Zealand dollar	.5480-.5490	.5445-.5458	.5360-.5390	Neutral	Neutral
Norwegian krone	5.8640-5.8690	5.9675-5.9725	6.2440-6.2665	Neutral*	Neutral
Portugese escudo	126.75-126.95	130.25-130.80	138.75-140.95	Neutral*	Remain long
Singapore dollar	1.6170-1.6180	1.6120-1.6160	1.6050-1.6160	Neutral	Neutral
Spanish peseta	94.80-94.90	97.16-97.31	103.95-104.25	Neutral*	Remain long
Swedish krona	5.4130-5.4180	5.5290-5.5385	5.8420-5.8620	Neutral*	Neutral

Explanatory Notes

*As per hotline update of July 2.

Currency expected to firm against both currencies.

Currency expected to strengthen against US\$ and weaken against DM.

Currency expected to weaken against both major currencies.

Currency expected to weaken against US\$, but strengthen against DM.

Term used to liquidate short position but does not imply a new buy recommendation.

Term used to indicate sale advice of previous long position, but does not imply a new short sale recommendation.

Buy	Buy
Buy	Sell
Sell	Sell
Sell	Buy
	Cover
	Liquidate

HOTLINE UPDATE

Tuesday, June 16:

The market letter is in the mail. There are no changes or new recommendations.

Friday, June 19:

There are no changes or new recommendations.

Tuesday, June 23:

There are no changes or new recommendations.

Friday, June 26:

There are no changes or new recommendations.

Tuesday, June 30:

There are no changes or new recommendations.

Flash Update, Thursday, July 2, 8:45 a.m.:

Liquidate long DM positions and all other EMS and EMS-related currency at the market and raise stops on September Canadian dollar to 8285, good anytime.

Friday, July 3:

This is a review of recommendations for the week.

On Thursday morning, July 2, we liquidated long DM position at approximately 6562, and we were stopped out of the Canadian dollar at approximately 8284. There are no other changes or new recommendations.

Flash Update, Tuesday, July 7, 11:10 a.m.:

Sell September crude oil at the market, currently at 2143, placing initial stops at 2200, close only.

Tuesday, July 7:

This is a repeat of the flash update this morning at 11:10 a.m. to sell September crude oil at the market, currently at 2143, placing initial stop at 2200, close only. There are no other changes or new recommendations.

Flash Update, Friday, July 10, 9:45 a.m.:

In keeping with our comments in the last newsletter, we would like to make the following suggestions. Cover all S&P outright short position, and liquidate put options should September S&P reach 41675 on intraday basis, and stand aside.

Friday, July 10:

This is a review of recommendations for the week.

On Tuesday, July 7, we sold September crude oil at approximately 2143, placing stop at 2200, close only.

On Friday, July 10, we recommended to cover all S&P outright short positions and liquidate put options should September S&P reach 41675 on intraday basis, and stand aside.

Tuesday, July 14:

There are no changes or new recommendations.

Friday, July 17:

There are no changes or new recommendations.

Tuesday, July 21:

There are no changes or new recommendations.

Friday, July 24:

This is a complete summary since our last market letter, dated June 14, of all liquidations of open positions and new recommendations that remain outstanding.

On Thursday, July 2, we liquidated long DM positions at 6562 as well as long EMS and EMS-related currencies. In addition we were stopped out of long September Canadian dollar at 8284.

On Tuesday, July 7, we sold September crude oil at approximately 2143, placing stops at 2200, close only. On Tuesday, July 14, we covered outright short S&P positions and liquidated S&P put options when September S&P traded above 416.75 as per Hotline of July 10.

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Subscription Enquiries for
Friedberg's Commodity & Currency Comments
347 Bay Street, 2nd Floor
Toronto, Ontario, Canada
M5H 2R7
(416) 364-1171

Trading and Managed Accounts

All enquiries concerning trading accounts should be directed to:

In Canada
Friedberg Mercantile Group
347 Bay Street
Toronto, Ontario M5H 2R7
(416) 364-2700

In U.S.
Friedberg Mercantile Group Inc.
67 Wall St., Suite 1901
New York, N.Y. 10005
(212) 943-5300

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