

# FRIEDBERG'S

## COMMODITY & CURRENCY COMMENTS

Friedberg Commodity Management Inc.



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### The monetary time bomb

Beware! A monetary time bomb is ticking away. And it will likely explode into the ugliest inflationary episode since the '70s.

It will, as nearly all major human events, come as a shock, wreaking havoc in the heretofore well behaved money, capital, and commodity markets.

Note: While these opening sentiments were crafted with the intention to grab our readers' attention — being perhaps overly dramatic — they should not be taken lightly. Here's why.

Inflation is and has always been a monetary phenomenon. Economic expansions and contractions play only a minor role in price level fluctuations; when they do, it is primarily via the demand-for-money function. The demand to hold monetary balances will diminish during an expansion/boom (as investment and spending opportunities are multiplied), causing the demand to fall below trend; for any given level of money supply, inflation will accelerate. Conversely, during a recession/bust, the demand to hold monetary balances may well increase (a result of economic uncertainty and/or liquidity requirements), causing the demand to rise above trend; as the supply for money is "absorbed" by larger than trend increases in the demand for money, inflation will tend to decelerate.

The key terms are "above trend," which produces an acceleration of inflation, and "below trend," which produces a deceleration of inflation. A slow and persistent *secular* rise in the demand for money (possibly a function of rising real income) will, in the long run, "absorb" part of the increase in the supply of money, slowing the annual rate of inflation to below the annual increase in money supply.

The demand for monetary balances can also be affected by fluctuations in the real rate of exchange. The desire by non-residents to hold increasing amounts of the home currency, anticipating better times ahead (more growth, lower taxes, better terms of trade, etc.) is the equivalent of an increase in the demand for money. A rising exchange rate, then, will tend to "absorb" part of the increase in money supply. Conversely, non-resident liquidation of home currency balances is the equivalent of a drop in the demand for monetary balances, i.e., a falling exchange rate will exacerbate the inflationary impact of money supply increases.

Our simplistic model is now complete. Cyclical economic fluctuations and currency gyrations will affect the

short run demand for monetary balances and, thus, cause inflation rates to deviate, at times significantly, from increases in the supply of money. Real incomes will affect the long run trend demand for monetary balances — in a slight but measurable way. Allowing for these effects, it is obvious that increases in money supply, in the long run, are paralleled by increases in prices. And so, to take an example, M1 (narrow money supply, basically transaction balances) grew at an annual 3.8% pace from 1954 to 1973 while consumer prices rose at a slightly lower 2.7% rate. For the period 1973 to 1990, this relationship changed very little: M1 grew at an annualized 7% rate, while consumer prices rose at a 6.6% rate.

These effects have been noted time and time again by monetarists only to be dismissed by non-monetarists during those periods in which prices and money supply refused to dance to the same tune. A better understanding of the *demand* side of the equation, as we have seen, however, would regain for monetarists their well-deserved reputation. (A technical

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Contributions by Albert D. Friedberg, Neil Reynolds, David B. Rothberg, 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.

note: Since money supply is directly controllable via the monetary base, reverse causation, i.e., inflation to money supply, is a non-issue.)

Putting theory into practice, we observe that the great inflation of the '70s erupted rather unexpectedly (or so it would appear to non-monetarists) in the first quarter of 1973, a little over two years after the trough of the 1969-70 recession *despite the fact that unit labor costs had moderated their rate of increase* to an annualized rate of 2.8% over the preceding three years, from 6.3% in the 2Q 1967 to 1Q 1970 period. In that fateful quarter, wholesale prices jumped at an annualized 20.9%. For the year 1973, wholesale prices jumped 9.1%, followed by an even more torrid 15.4% pace in 1974; consumer prices went up 6.2% and 11% respectively.

What were the monetary conditions leading to that shock? From the November 1970 trough the monetary base and M1 had grown by over 17%, a far faster rate than anything experienced in the first two years of the previous three recoveries (see Charts 1 and 2). *At the same time*, the US dollar had been falling continuously: In the two years before the trough, the US unit fell 8.7% *vis à vis* the DM; in the subsequent 28 months to the first quarter of 1973, it fell an additional 22.5%.

Armed with this information, monetarists would have drawn the only correct inference: Inflation, somewhat restrained in the first two years of the recovery (4Q 1970 to 4Q 1971), was about to explode. While the exact timing of the explosion remained elusive, its certainty was not in doubt. The *catalysts* may have been the Soviet grain purchases of 1971-72; the true cause was none other than the accelerated pace of monetary expansion.

A similar monetary expansion following the 1981-82 recession (see Charts 1 and 2) did not result in a quickening of the pace of inflation. Non-monetarists and anti-monetarists gloated at the apparent "failure" of the monetarist model; contrary to the 1970-74 episode, consumer prices rose less than 4% for the four years subsequent to the 1982 trough. No account, however, was taken of the extraordinary rise of the US dollar during this period.

For the two years *before* the trough, the US dollar appreciated 33% *vis à vis* the DM; over the subsequent 28 months it rose an additional 24.3%! While, clearly, *some* of the monetary conditions were present following the trough of the 1982 recession, other conditions, specifically the significant *non-resident* increase in the demand for US monetary balances, more than offset this inflationary source.

The net result for the period 1982-87 was an increase in money supply of 10.4% and a rise in consumer prices of only 3.3%. The "fortunate" swing element was the Reagan-inspired rise of the US dollar (a real as opposed to nominal event) and perhaps, too, the 1986 breakdown of the OPEC cartel, which brought oil prices down by more than 50%.

What are the monetary conditions today? Charts 1 and 2 (fixing May 1991 as the trough of the 1990-91 recession) paint a worrisome picture: M1's rate of growth for May 1991 - Sept. 1992 exceeds anything yet seen thus far in the post-war history of economic recession (achieving an index of 116.6,

i.e., a 16.6% growth in M1). As to the monetary base, the pace is only slightly slower than the one observed following the 1982 recession and clearly faster than the one observed during all previous recoveries.

At the same time, poor growth prospects have encouraged non-residents to liquidate dollar balances: In the two years before the 1991 trough, the US dollar fell approximately 12%; since then, it has fallen (to the end of September 1992) an additional 17.8%.

The two key elements capable of causing a strong resurgence of inflation are now present: An excessive monetary expansion accompanied by a drop in the demand for monetary balances, which will clearly be accentuated in the course of the ongoing *economic expansion*. Unlike 1980-84 but very much like 1969-73, we may be on the verge of another virulent attack of inflation.

A slight digression is now in order.

Money supply increases, the counterpart of growth in bank assets, may be the result of either increases in bank investments or increases of bank loans, or both. In their linkage of inflation to the growth of money, monetarists do not distinguish between a money supply increase that originate in an increase of bank loans or one that originates in an increase in bank investments. The logic of this position is unassailable, for if the banking system would never make any loans to the private sector but would finance only the public sector's excess of spending over revenues, it would be hard to argue that this activity would not cause inflation. Both private and public credit, in a fiat system, will finance *excess spending*, and as a consequence are equally as inflationary.

An increase in bank loans may *follow* but does *not* necessarily need to *precede* an inflationary surge. As asset prices firm and profit margins improve, both likely to be the result of an acceleration of inflation, commercial banks gain confidence and begin to increase their loan portfolios, which tend to be far more profitable than public sector credit, i.e., the holding of Treasury debt.

Over the past two and half years, banks have added more than \$210 billion of Treasury debt to their holdings. This unprecedented increase has radically altered the asset side of the commercial banking system (see Chart 3). For the first time since the '50s, investments, i.e., public sector credit, exceed total loans, i.e., private sector credit. In line with our earlier comments, this massive shift in the composition of the asset side of the banking system in no way guarantees that inflation will not begin to accelerate.

At the risk of being to repetitious, *public credit is as inflationary as private credit*. Those who focus on bank loans to predict price level fluctuations will be badly misled. In the present cycle, bank loans are likely to *follow* an acceleration of inflation. Ominously, the huge buildup of bank investments will immunize the banking system from any Federal Reserve tightening action, as banks will fund increasing loan demand by liquidating these holdings. This process has profound ramifications, some of which we alluded to in our Feb. 16, 1992, issue, and some of which we discuss in our interest rate article.

In sum, monetary data lead us to believe that conditions are right for a sooner-than-expected resurgence of inflation, or rather an acceleration of inflation. The inevitability of this event is further supported by a powerful psychological factor: The public has been lulled into believing that inflation is dead. And all important economic events in human history come as surprises.

Forwarned is forarmed.

**STRATEGY:** This scenario has highly significant implications, most of which cannot be described except in a very

general way. Its timing and magnitude are necessarily imprecise. Cautious investors will want to effect portfolio changes early on so as not to be caught off guard.

Interest rates will rise, perhaps quite dramatically. Commodity prices will rise also perhaps quite dramatically. Equity prices after perhaps some early gains from the expansion of profit margins, should suffer rather dramatically from the rise in yields. The US dollar will appreciate in real terms but it is difficult at this early stage to know whether the predominant feature will be the rise in relative inflation vis à vis Europe and Japan or an appreciation of the currency in nominal terms.

Chart 1

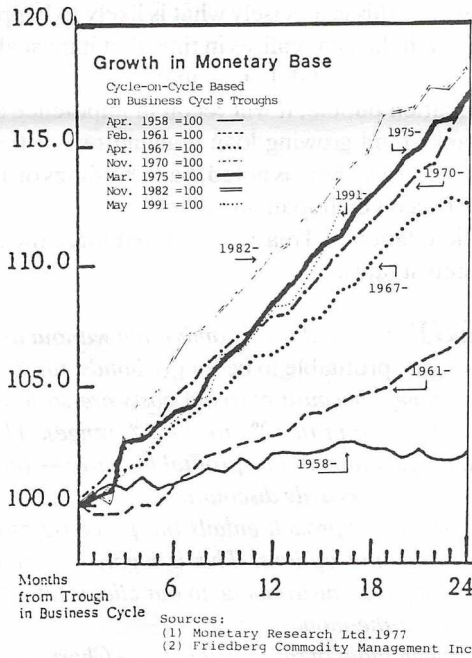


Chart 2

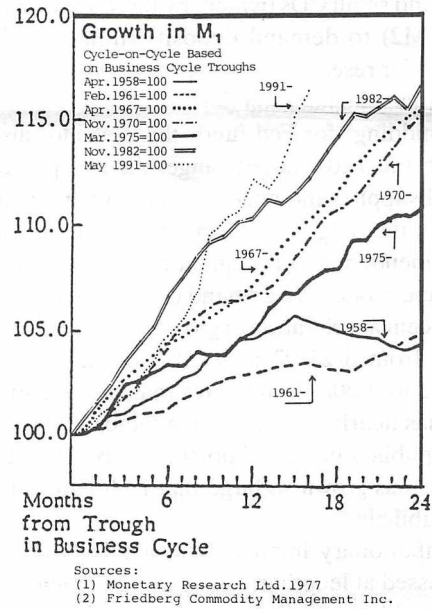
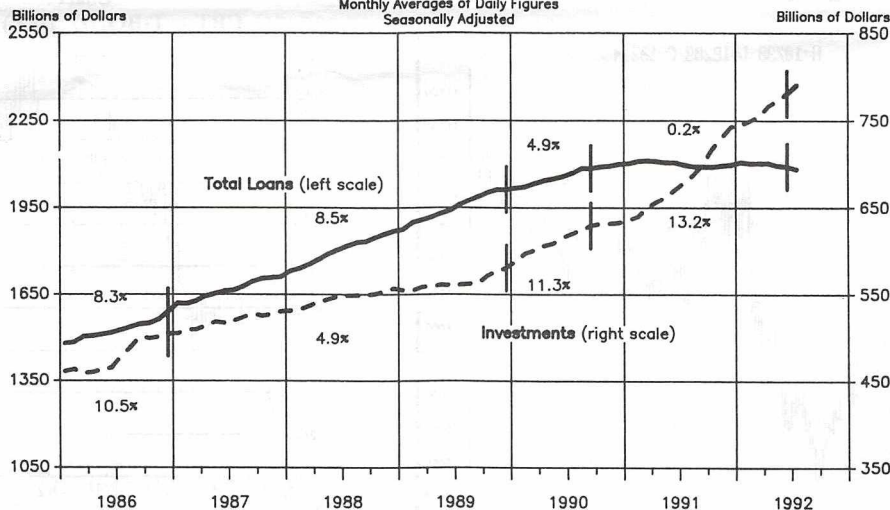


Chart 3

**Commercial Bank Loans and Investments**



Bank loans do not include domestic commercial interbank loans.

Percentages are annual rates of change for periods indicated.

Prepared by Federal Reserve Bank of St. Louis

**INTEREST RATES**

# Going up

The fall in interest rates has almost certainly come to an end.

In recent months, bank reserves have grown at a formidable 20% per annum pace. These rates of growth, in turn are determined by the Fed's policy of targeting interest rates. The explanation is rather simple: As Fed funds are lowered (and the overall spectrum of short-term rates falls), the opportunity cost of holding transaction balances falls. A switch away from large and small CDs (which, by the way, form part of the "sluggish" M2) to demand deposits (inflating M1) forces banks to bid for reserves, as the latter's reserve requirements are substantially higher than the former.

The "bidding" for Fed funds threatens to raise interest rates above the Fed's target range. At this point, the Fed obliges and supplies the necessary reserves to maintain Fed funds within the range. Thus, an interest rate target spells a loss of independence as the quantity of reserves, the monetary base, and money are demand determined.

The recent acceleration of growth in bank reserves (14.7% annualized from 6/24/92 to 9/2/92 and 22.5% annualized from 8/5/92 to 9/30/92) indicates that the opportunity cost of capital has nearly ceased to be a factor in the determination of the public's preferred portfolio mix. The pool of very liquid assets has grown so large that it threatens to become highly destabilizing.

The inflationary implications of this process were already discussed at length in our opening comments. Further cuts in rates will do very little more than to further swell bank reserves and demand deposits now, creating even more serious problems in the future.

A moment's analysis will illustrate this problem: As

interest rates rise and the opportunity cost of holding non-interest-bearing deposits rises along, a reverse shift in deposits begins to occur: from demand deposits to time deposits. Banks begin to free up reserves ("free reserves" rise, in the banking lingo) and thus are able to grow assets at an accelerating pace.

If the Fed merely continues to target funds, it will be too late in braking the explosive growth in assets. In the initial stages, however, this is precisely what is likely to happen.

And *even* if the Fed realizes in time that it must abandon interest rate targeting (it did once, under Volcker in 1979) to stop the inflation bubble, it will recoil in impotence as commercial banks fund growing loan demand out of their vast cache of Treasuries. (For, as noted, bank holdings of Treasuries already exceed their loan portfolios).

This liquidation of Treasuries will reinforce the upward trend in interest rates.

**STRATEGY:** *Selling short T-bonds is not without its risk. In effect, it is highly profitable to be long T-bonds, financed with short-term money, because carrying costs are so low (repos and Fed funds trade in the 2% to 3-1/4% range). The short seller's risk is a function of this "profitable" carry — this is why distant positions are heavily discounted.*

*A limited-risk approach entails the purchase of distant, out-of-the-money put options. This is highly recommended. We are currently making available to our clients late 1993 and early 1994 out-of-the-money options.*

*Given magnitudes of the recent fall (see Chart 4), patience should be exercised in establishing outright short positions. We advise selling only on rallies of 1-1/2 points from any lows.*

Chart 4

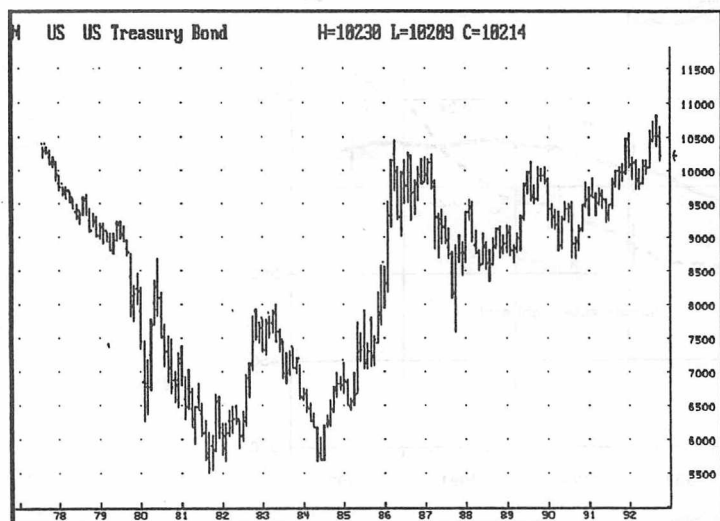
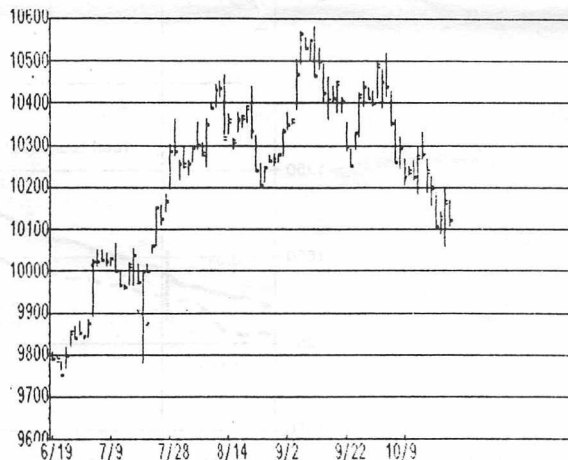


Chart 5

CBT - T-BOND (DAY) MAR 93



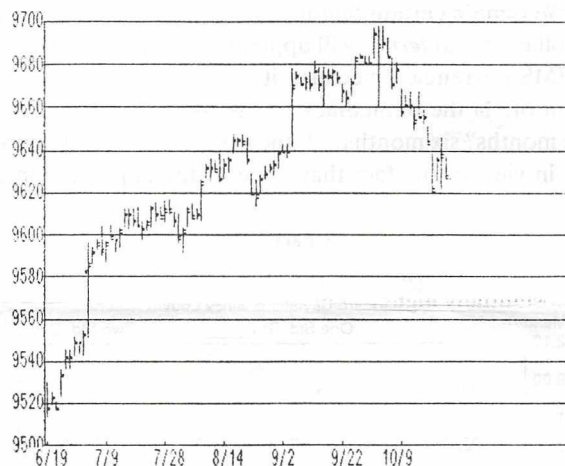
**EURODOLLAR FUTURES**

## Low risk bet on rate reversal

On October 2, we advised, via the Hotline, selling March '93 Euros, then trading at 9688. Given the current cash levels, the trade represented a *very* low risk opportunity to bet on an early reversal of rates.

**STRATEGY:** *Cash rates have climbed to 3 9/16%, putting March '93 at a still-slight 16 basis point discount. Lower stops to 96.50, close only.*

Chart 6 - 3 MTH EURODOLLAR MAR 93

**US DOLLAR**

## Stand aside

Last month we concluded that the US dollar had bottomed "because currencies follow the path of profits and better economic performance. Recession in Europe is spreading with the downturn in Germany; the US, on the other hand, protected by an extremely cheap currency, continues on a recovery path."

The trade "overvaluation" of the DM has had a dramatic impact on one of Germany's most important industries — engineering, with sales of \$160 billion — leading one to suspect that the same may be happening across the entire tradeable sector. According to Mr. Berthold Leidinger, president of the VDMA industry association, the sector would have to cut costs by up to 30% to remain competitive. The average net return on capital had fallen to an all-time low of less than 1.2%. He added that the 40% appreciation of the deutschmark against the dollar and a revaluation of 20% against the yen over the past three years was an especially heavy burden.

It is clear that reunification has had a detrimental effect on Germany's tradeable sector. The swing in the current account, now running at a deficit of approximately DM25 billion, has "absorbed" a good part of the excess spending in the economy. In this respect the deficit is beneficial and the overvaluation of the DM necessary. A lower exchange rate for the DM runs the risk of exacerbating inflationary pressures as a healthier tradeable sector vies aggressively for limited resources with the non-tradeable sector. Since lower

interest rates would automatically translate into a lower DM, the Bundesbank would have to proceed with great caution, *if at all* (at least for now).

The strange policy mix of exchange rate (ERM and a broad DM/\$) and money supply (M3) targets finally demonstrated its inherent, logical incompatibility: force intervention leading to a swelling of money supply. Partly as a result, M3 continues to run well beyond the 3% to 5% target.

In a recent report, the Bundesbank disposed summarily of the argument that the inverted yield curve was having an impact on M3 by focusing monetary growth on short-term deposits. It argued that "a large part of the interest-rate-induced portfolio shift took place *within* the money stock M3 as is shown by the sluggish expansion of sight deposits and low-interest-bearing savings deposits at statutory notice." It concludes that "the indicator quality of M3 is not fundamentally called in question even in the special circumstances prevailing in 1992." It is worthwhile pointing out that even M1 is growing too rapidly: In September, its year-on-year rise was 8.6%. This, too, militates against an early and substantial easing of rates.

Our conclusion remains unchanged: The US dollar has bottomed, as relative economic performance has begun to favor the US. Bottoming, however, does not mean the nominal exchange rate will shoot up from these levels. A continuous foot on the brake on the part of the Bundesbank may delay considerably the decline of the DM and its EMS-

related currencies. And even a test of the recent US dollar low is still a real possibility (although a decreasing probability).

What's more, the US dollar, via high relative inflation, may rise in real terms *vis à vis* the EMS currencies without a pronounced rise in the nominal exchange rate. Or, it may do a little bit of both.

We remain certain that in coming months and years the US dollar, in *real terms*, will appreciate *vis à vis* the DM and the EMS currencies, because it is too cheap. We are not certain of: 1) the immediacy of the move — immediately? three months? six months?; 2) the extent of nominal appreciation in view of the fact that some of the appreciation can

take place via higher US inflation. Considering the well established Louvre Accord range (see the discussion in our March 15, 1992, issue, and see Chart 7) and our views on future US inflation, it is likely that the dollar's rise, in nominal terms, will not exceed the DM1.85 - DM2.00 upper range.

**STRATEGY:** At DM1.53/\$, the spot level is slightly over-extended and contains little room for disappointment. Too, forward carry is expensive. Finally, implied option volatilities have soared to over 20%, indicating that the market is well prepared for wide movements (and therefore they are not likely to happen). Only the very nimble can profit. Stand aside and wait for an opportunity.

Chart 7

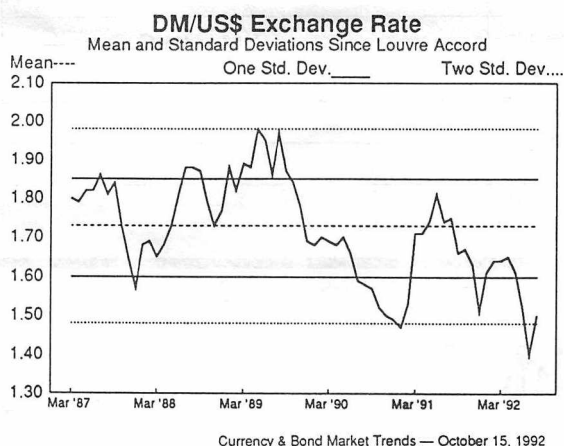
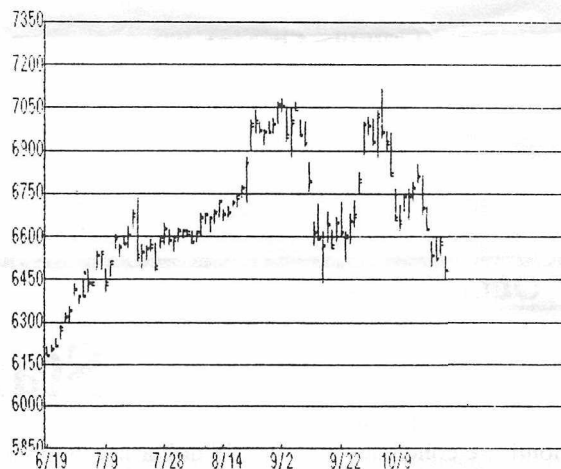


Chart 8 - CME DEUTSCHE MARK DEC 92



**UNITED KINGDOM**

# Cashing in as the Brits lose their cool!

Having regained monetary independence — after a rather hurried and unflattering exit from the EMS — the Major government is likely to throw away caution and pump the prime until more solid signs of recovery appear.

Recent news has been distressing: A British Chamber of Commerce survey of 8,200 companies has concluded that British business has suffered a “deeply disturbing” slide into a second leg of recession last month with business confidence “seriously undermined.” The *Independent-Oxford* weekly indicator (see Chart 9) has confirmed this double dip. The deflation in house prices continues while mortgage defaults skyrocket. Unemployment is relentlessly approaching 3 million workers. Lack of confidence in government management is rampant, and yet the stock market is very near its all-time highs (see Chart 10).

What gives? Psychologically, it's a classic case of “climbing a wall of worry,” all so typical of early bull markets. More importantly, the “fundamentals” are quite constructive. In the first place, dividend yields, at 4.72%, are high in relation

to UK long-term gilts of 8.93%, at least by the historical standards of the post-war period. More interestingly, the *Financial Times-Actuaries All-share Index* (500 companies) trades at a mere 16.3 times (depressed) earnings, or an earnings yield of 6.1%, which compares extremely favorably with index-linked gilts.

As an example, the 2½% of 2009 gilt indexed to the Retail Price Index, assuming inflation rates of 10% and 5%, yields a paltry 3.65% and 3.86% respectively. A British investor, looking to preserve capital against what may be a renewed inflationary cycle and seeing this 250 basis point spread would be well justified in choosing traditional equities over index-linked bonds.

Regardless of how quickly the British “reflate,” the equity play is attractive. The only uncertainty is the speed of the advance. A mad “dash for growth” will produce a dramatic and speculative advance that, eventually, will be cut short by severe balance of payments and currency constraints and a repentant Bank of England. A very slow reflation will pro-

duce a saner and more durable bull market.

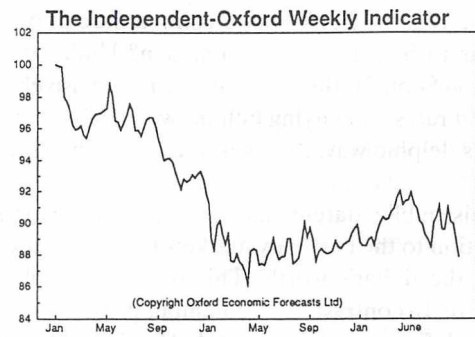
From a currency point of view, however, only the first option can produce a worthwhile trend: A mad dash for growth can take Sterling down to DM2.25 or even lower.

However, should Prime Minister Major regain some composure, Sterling is likely to remain locked in a DM2.40 - DM2.50 range. This suggests selling Sterling versus DM at the upper end (around DM2.50), awaiting new policy initiatives.

**STRATEGY:** Climbing a wall of worry, the British stock market is likely to post significant advances in the months ahead. Buy December '92 FT-SE 100 at market; place initial stops at 2200, close only.

Sell the "cross" at DM2.50, placing initial stops at DM2.53, N.Y. close only.

Chart 9



The Independent-Oxford indicator takes into account a wide range of data covering the financial markets, industrial activity, future output, consumer spending and housing.

Currency & Bond Market Trends — October 15, 1992

Chart 10 – LIF FTSE 100

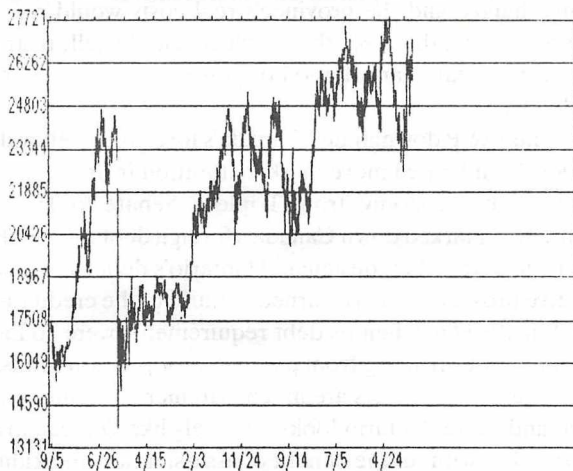
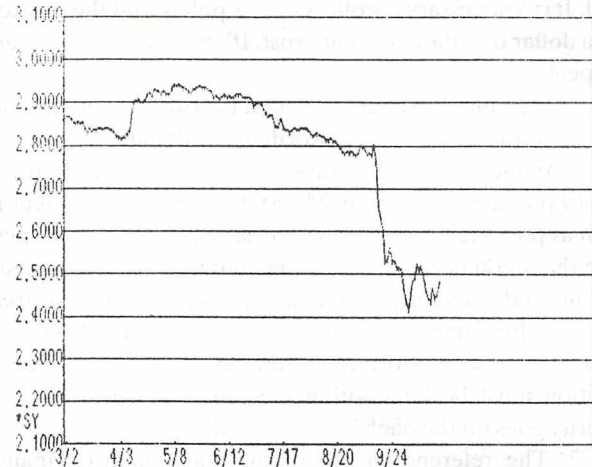


Chart 11 – £/DM – DEC



**CANADA**

**Canada's real problem**

Imagine a bungee jumper, girdled with weights, in free-fall. Imagine the guy on the bridge cutting the rope.

Imagine watching from the bank of the river. You have to anticipate a thud. Perhaps you will witness a miracle. You should not, however, bet your money on it, or anyone else's.

Bank of Canada Governor John Crow kept a rope on the Canadian dollar during its spectacular plunge in the national referendum campaign on the Charlottetown Accord. He wanted an orderly descent, with no great mess at the bottom. From a central bank perspective, these thrill jumps are best performed in slow motion.

The money markets super-spooked twice during the referendum campaign; first on Sept. 8-9, then on Sept. 21 (and hyperventilated several times in subsequent days). These particular days marked the dollar's full-cent-a-day declines, and accomplished two thirds of the "constitutional devaluation." The dollar began the campaign on Aug. 28 at 83.5¢; it closed the campaign on Oct. 23 at ...¢.

With the bleachers filling fast on the "No" side of the river banks, the campaign provided a daredevil environment for the dollar's fall. The dollar, however, began its fall a year ago. When Finance Minister Don Mazankowski declared the dollar "fundamentally sound" on Sept. 21, he ignored the fact that the dollar has declined dispassionately through constitutional optimism and constitutional pessimism. The constitutional package contained no provisions for the repeal of the laws of motion. Something heavy weighs down the dollar. It wasn't merely the constitution, and it didn't disappear on Oct. 26.

Mr. Crow has made his own intentions as clear as a central bank governor can. In the weeks ahead, he will cut the interest rate rope that now suspends the dollar. And the markets will determine the worth of the dollar. Except to maintain an orderly market, the Bank of Canada will not try to stop a further decline; there will be no safety net.

In playback of the tape, it's apparent that the bank intervened reluctantly, and at first moderately, during the

campaign. This restraint, though, produced a cynical interpretation: Was the Bank encouraging a precipitous drop in the dollar to help the "Yes" campaign? Under the market pressure on Sept. 21, the bank intervened decisively, pushing up interest rates and buying billions worth of dollars.

In its delphic way, the bank was telling markets to shut up — for the rest of the campaign.

In his public statements, Mr. Crow has expressed his appreciation to the currency markets for their "independent view" of the dollar's worth. This is a remarkably rational perspective. In contrast, the September pressure on the franc left France's finance minister, Michel Sapin, sputtering about the good old days when currency speculators went to the guillotine.

Mr. Crow has defined the principal goal of Canadian monetary policy as a currency that people can trust. He has been remarkably consistent and persistent in pursuit of this goal. It is a necessary corollary of this policy that the markets get a dollar that they, too, can trust. It's now the market's turn to speak.

In the immediate future, watch for two happenings that will deliver messages on the worth of the dollar:

1. Without the constitution to obsess (or abscess) them, the 10 premiers and Prime Minister Mulroney will meet as soon as possible for an "economic summit" designed to massage the markets and comfort the country. The assignments are mutually exclusive. Unless the summiteers address investors' fundamental concern — the rise in Canada's public debt — they will send out a strong worry signal. A federal election must be held within the next 12 months. Which priority goes on the back burner: politics or economics?

2. The referendum out of the way, Ontario Finance Minister Floyd Laughren will give a Hallowe'en report on the financial mess in Canada's dominant province. Will it be trick or treat? Ontario's economic crisis is already a significant weight on the dollar; it's getting worse. Will the NDP government do what's necessary to cut spending?

Historically, Ontario has been Canada's economic Rockeeter, but its prolonged loss of thrust in this recession now makes it more of a deadweight on the dollar than Ottawa. Neither government will meet its deficit target in this fiscal year, which is not surprising. (In fact, no Canadian government will.) Ontario, though, will miss by billions. Rather than a \$10 billion deficit this year, Ontario could produce a \$15 billion deficit. Its prospects for 1993-94 appear equally dismal.

The result? In two years, at the current rate of mismanagement, Ontario could produce a deficit equal in magnitude to a one-year federal deficit. This is an unprecedented phenomenon, and it comes from a provincial sideshow that many foreign market analysts don't watch. At the C.D. Howe Institute, economist Irene Ip expects Canada's total public debt to rise by \$45 billion in 1992-93, an increase that approaches 10%. Public debt will rise by March to 85% of GDP; this year, it was 75% of GDP; in 1982, it was 40% of GDP.

Mr. Laughren still says that Ontario will beat its deficit target (\$9.9 billion) this year. He is not credible; and Ontario

Premier Bob Rae has shown little interest in managing the catastrophic treasury. In two years, Mr. Laughren has been compelled to revise his calculations six times. To maintain a semblance of credibility, the government must impose restraint measures equivalent to the closing of the mine pits in Britain. Mr. Laughren wants \$2 billion in mid-year spending cuts, and the layoff of 3,000 to 5,000 public sector workers; the cabinet is still dithering.

He has prepared a wide range of tax increases, disguised as user fees. The options he has considered illustrate his desperation — everything from provincial licences for bicycles to sales tax on the sale of homes, from road tolls to reduction in transfer payments to municipalities.

Further, he has contemplated the wholesale dumping of Crown assets (the Liquor Control Board of Ontario, GO Transit trains). In most of these cases, though, the province would lease the operation back, very little money would change hands, and the province's real costs would rise. At Ontario Hydro, the asset the province should sell, restraint has mostly meant cancellation of power projects that aren't needed anyway.

When S&P downgraded Canada's foreign currency debt on Oct. 14, it helped move market attention from the constitution to the economy, from Triple E Senate to Triple A credit. S&P marked down Canada's foreign debt to Double A plus from Triple A; it designated Ontario's debt as AA, with negative prospects. This returned Ontario to the credit rating it had in 1982-86, when its debt requirements were so low it met them by borrowing from public sector pension funds.

Ontario's prospects are much grimmer this time round. More and more, Ontario looks and feels like Quebec in the 1970s — but without the benefit of assassination and kidnapping to explain the flight of people and capital. (S&P rated Quebec debt as AA minus, with negative prospects; the two provinces have essentially converged in creditworthiness.)

The risks aside, expect Mr. Laughren aggressively to prop provincial spending. Watch for the mischievous removal of capital spending from the province's March budget. Watch for the province to circumvent the markets to meet its debt-money needs. (In competition with Ottawa, it could issue its own savings bonds; in competition with commercial banks, it could raise interest paid on deposits in Ontario's own provincial bank.)

Can Ontario count on a recovery to rescue it from its crisis? The traditional, strong "snap-back" from recession hasn't happened; no one now expects much snap anyway. And a return to traditional good times in Ontario would require an exceptional recovery. It would require three years of GNP growth at 6% a year; or four years at 5%; or six years at 3.6%.

Assume anemic growth in much of Canada for the next year or two; assume economic atrophy in the rest of the country. Assume a rise in public debt on the current trajectory. Canada's public debt could easily hit 100% of GDP before it peaks, taking the country into territory already explored by Italy.

Assume that Ontario responds to its debt crisis by raising taxes. Since Ontario represents one third of the country's economy, the implications are equally significant for ordinary people and investors. Canada already taxes 40% of GNP, a "danger zone" by any standard. Further tax increases can only erode the already ravaged tax base.

Ontario's crash program to raise money will tax the recession, will weaken the recovery, and will increase the "tax wedge" between US and Canadian investment. It is an extremely stupid public-policy response to the problem of too much spending and too much taxation. The probable result: More capital flight, and more people flight.

Canadian governments have a choice. They increase taxes and compel Canadians to pay for the public services they receive. Or they reduce spending. Either way they risk the fury of the public and riotous demonstrations in the streets.

Inexorably, deficits work to raise tax burdens and impose higher deadweight costs; these produce slower economic growth. People know this, intellectually or instinctively, and it infuriates them. To compensate themselves for real losses and anticipated losses, they paradoxically seek more government spending.

This economic impulse will dominate Canada during the coming election year. It — not the constitutional aftermath — is the real source of uncertainty in Canada. Will the federal Conservative party stay the course on restraint? In S&P's credit-rating report, the agency said that its conclusions "assumed" that deficit-reduction would remain a dominant policy goal, regardless of who forms the next government. Do all of Canada's political parties agree?

As the US campaign has indicated, people are disenchanted with deflation; they found inflation more rewarding. They'll be asking for it back. After their experience with the constitution, the politicians will be tempted to give them

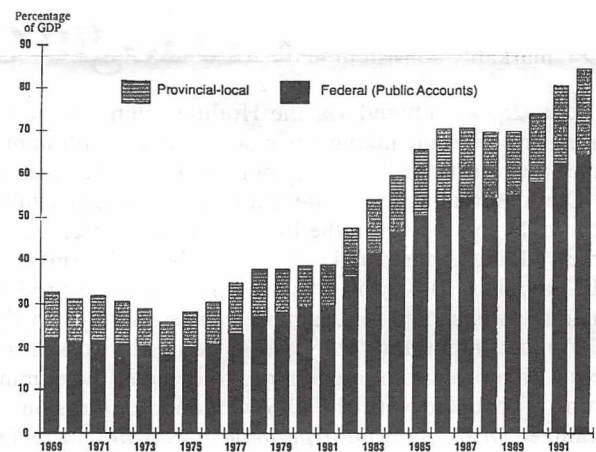
everything they want.

Mr. Mulroney will go to his "economic summit" with a multi-billion-dollar public-works program in his pocket. As the prime minister stands in a semi-circle with the premiers to have the official photograph taken, the premiers will have their hands in the pockets of the provinces next to them. Welcome to the next chapter in Canadian federal-provincial relations. But this time around, don't expect Ontario to play the role of Mr. Nice Guy. This time, Mr. Rae especially will want more — much more.

— Neil Reynolds

Chart 12

Net Debt In the Federal and Provincial-Local Sectors, 1969-92  
(Financial Management System basis)



SOURCE: Irene K. Ip, C.D. Howe Institute. Data, Statistics Canada, Department of Finance. (For 1990, 1991 and 1992, some calculations are estimates by Irene K. Ip)

## CANADIAN DOLLAR

# We stand aside

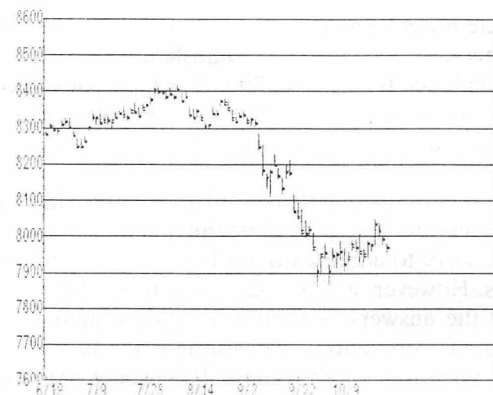
Our respect for the Bank of Canada continues to grow. By hoisting short-term interest rates to 525 basis points above comparable US rates, it forced enough short covering to halt the downside momentum, and nipped in the bud the near-panic conditions that were developing.

The Bank continued to insist that it has no specific exchange rate target in mind: It merely acts to smooth out violent fluctuations. Nevertheless, it is obvious that the major trend has turned down. Canada needs to achieve much larger trade surpluses to offset the steady and growing long-term capital leak.

Despite extremely depressed domestic demand, the current account remains in the red to the tune of \$29.9 billion. Under normal conditions, this gap can be comfortably financed; given the aftermath of the ongoing constitutional wrangle and the presence of a true socialist at the helm of Canada's richest province, the gap *cannot be easily bridged*. Ergo, we need high interest rates and a "cheap" exchange rate.

**STRATEGY:** We covered quite profitably our Canadian dollar short positions as per the Hotline Update of Oct. 14. Stand aside for now.

Chart 13 – CME CAN. DOLLARS DEC 92



**STOCK INDEXES**

## Upside breakout imminent

The market continues to take in stride a string of unfavorable news: a falling bond market, the increasing likelihood of a Clinton Presidency, very sluggish business conditions, a Dow theory bear market signal.

The selloff of Oct. 5, which saw the S&P 500 collapse 1980 points, or 4.8% in a matter of a few hours had the effect

of technically strengthening the market by eliminating a large contingent of nervous Nellies.

We still expect this market to break out on the upside.

**STRATEGY:** Long December futures positions; place stops at 399, close only. Remain long call options.

**CRUDE OIL**

## The logic of falling prices

On Sept. 28, we advised via the Hotline selling crude oil futures, or preferably taking advantage of cheap option premiums, purchasing at-the-money puts on deferred contracts.

Our logic was based on the fact that: 1) it was inevitable that Iraq, at some point in the future, would re-enter the oil market, adding as much as 4 million barrels per day (mbd) to OPEC supplies; 2) Kuwait was steadily increasing production and was expected to regain pre-war levels very shortly; and 3) most importantly, the rise in domestic Russian oil prices with a promise of much more to come in the coming months — coupled with the CIS economic depression — guaranteed an ever-growing exportable surplus, despite falling production.

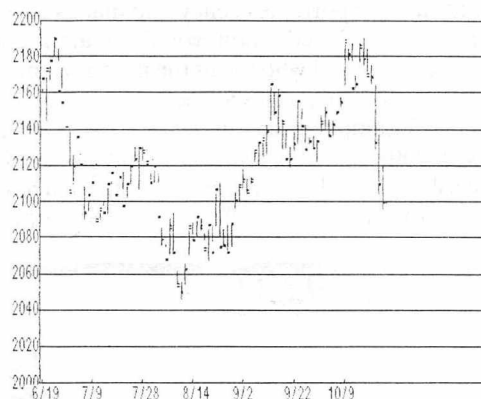
The latter conceivably, could have a devastating impact on world prices, in much the same way as Soviet selling caused a collapse in aluminum and nickel prices.

In recent days, it has been reported that Iran has increased outturn from 3.4 mbd to 4 mbd, becoming the second largest selling member in OPEC. Clearly, the erosion in real prices is forcing an increasing number of producers to look to growth in volume as a way to offset the fall in real revenues.

We continue to believe that *much* lower, single digit, oil prices are in store over the next few years.

**STRATEGY:** Retain long-term put options. Place stops on March '93 futures at 21.40, close only.

Chart 15 – MAR 93 CRUDE

**COMMODITIES**

## Assets again?

The article my colleague and boss Al Friedberg has contributed to this issue is an absolute bombshell. If it proves true — and the evidence is so compelling that I am convinced — it means commodities will come to be regarded as an asset category for the first time since 1984 — and, legitimately, since 1980.

Questions immediately begged are: When will it happen and which commodity/ies will be the first to go?

I am sorry to admit I do not have the answers to these questions. However, giving voice to some of the issues that surround the answers — even in a random manner — is a good form of preparation for investment action.

The when is anybody's guess. It is even more than a bit

naive to declare when an economic phenomenon occurred in history let alone when it will occur in the future. With history in mind, one cannot help but stare straight back to 1971 and say, naively or not, that it was the then-USSR purchase of American wheat that began the price flight.

That purchase was a shock and it came from the demand side of the equation — not the supply side.

I would not be surprised if it was another surprise buy from some as yet unidentifiable consumer that spawned the forthcoming boom. Would it be unwise to suggest that buyer could be China, the giant awakening from a near-century long hibernation. Free market making has become party policy in China and the country is growing at a faster clip

than any other on earth.

Has China ever purchased a statistically significant amount of cocoa? Or silver? Would it be unreasonable to imagine the ruling cadre of china looking to placate its reform-starved citizens with chocolate — sort of like Marie Antoinette did her confreres et soeurs with cakes. And while wishing nothing so little as to sound politically incorrect, would it not be true to suggest that orientals have had a particular predilection toward industries electronic — which tend to be substantial consumers of silver? (The Chinese, by the way, have an historical attachment to silver quite apart from any industrial usages; until the 1930s the country was on the silver standard).

Silver consumption has outpaced production for three consecutive years now. And the last we looked statistics covering existing inventories were very hard to come by — the implication being that the metal has been taken out of the public domain by strong hands and hoarded.

Cocoa remains one of the cheapest commodities on the

board. The Ivory Coast's recent declaration it will not permit purchases of mid crop and "small" beans thus reducing output to around 600,000 tonnes, well-entrenched industry decay in Brazil, and problematic weather in Nigeria appear likely, in combination, to cause a deficit of at least 100,000 tonnes, the second consecutive deficit year.

I am currently long both of these commodities as investments. They are both cheap. Both have little prospect of undiscounted negative fundamentals. And from a technical point-of-view, both have constructed solidly engineered bases. (Don't be fooled by the look of dollar-denominated cocoa deliverable in New York; the sloth has all been caused by arbitrage selling against falling sterling).

I advise owning them both outright via futures positions as far forward as liquidity provides safety. Rates being as low as they are make the contango fairly unonerous. And you may end up being the proud holder of the "first one to take off."

— David B. Rothberg

## FRIEDBERG CAPITAL MARKETS

Chart 16  
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, C\$, SAR, FIN, ITL, ARG) or revalue for JY, before the interest rate advantage/disadvantage is overcome by currency depreciation/appreciation. Rates as of October 22, 1992.

	US \$	NEW ZEALAND \$	AUSTRALIAN \$	DEUTSCHEMARK	SWISS FRANC	JAPANESE YEN	DANISH KRONE	BRITISH POUND	FRENCH FRANC	EUROPEAN CURRENCY UNIT	CANADIAN DOLLAR	SOUTH AFRICAN RAND**	FINNISH MARKKA	ITALIAN LIRA	ARGENTINEAN PESO
1 year	3.52%	Tourist '93 yields 6.07% (.5273 NZ/US)										ESCOM 11% '93 yields 11.30% (.2134 US/SAR)			
2 year	4.30%		CBA 14% '94 yields 7.21% (.6819 A\$/US)				Denmark 9% '94 yields 9.13% (6.34 Dkr/US)								
3 year	4.85%												Finland 11% '95 yields 12.48% (5.89 FIN/US)	NIB 12% '96 yields 13.15% (1658.4 ITL/US)	
4 year	4.37%			Bk. of N.S. '96 yields 7.91% (1.722 US/DM)		World Bk. '96 yields 4.36% (120.96 US/JY)		Sweden 8% '96 yields 7.45% (1.450 BP/US)	Credit Lyonnais '96 yields 8.67% (6.00 Ffr/US)		Ontario Hydro '96 yields 7.69% (1.4088 US/CD)				
5 year	5.88%										Ekspost finans '97 yields 8.16% (1.3827 US/CD)				
6 year	6.15%				Australia '98 yields 6.34% (1.3613 US/SF)										
8 year	6.49%									UK. 9% '01 yields 8.83% (1.1181 ECU/US)					
9 year	6.76%			World Bank '01 yields 7.21% (1.5652 US/DM)											BIC V '01 yields 20.21%
Spot Exchange Rate	-	.5403	.7205	1.507	1.3468	121.0	5.792	1.6287	5.106	1.3035	1.2430	.2295	4.771	1319.63	.99

\*For example, since a US\$-based investor would receive 763 basis points (1248-485) by holding the Finland 11% '93 bond, the FIM/US can depreciate to 5.85 FIM/US from the present spot exchange rate of

4.771 FIM/US over the next 3 years for the FIM 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.

### Recommended bond portfolio allocation for new portfolios

For new portfolios, we recommend the following investments:

Finnish Markka fixed rate bonds	15%	Argentina BICV	15%
Italia Lira fixed rate bonds	15%	US \$ Floating rate Notes	35%
US. \$ high yield CV bonds	20%		

Chart 17 - Foreign Currency Bonds

Date: October 22, 1992

WE OFFER THE FOLLOWING BONDS SUBJECT TO CHANGE WITHOUT PRIOR NOTICE:

ISSUER/MATURITY DATE/COUPON	BID	OFFER	CURR. ANN. YLD. TO MTY.	NEXT PAYMENT DATE
<b>DEUTSCHE MARK DENOMINATED</b>				
BANK OF NOVA SCOTIA 5 5/8%	92.40	93.15	7.91%	May 07
07/05/96 RRSP eligible				
WORLD BANK 5 7/8%	94 1/2	95 1/4	7.20%	Feb. 04
4/02/97 RRSP eligible				
WORLD BANK 9%	109.90	110.65	7.21%	Nov. 13
13/11/00 RRSP eligible				
<b>FINNISH MARKKA DENOMINATED BONDS</b>				
REP. OF FINLAND 11% 15/6/95	95.95	96.70	12.48%	Jun. 15
<b>ITALIAN LIRA DENOMINATED BONDS</b>				
NORDIC INV. BANK 12 3/4% 19/04/96	97	97 3/4	13.15%	Apr. 19
<b>SWISS FRANC DENOMINATED BONDS</b>				
GOVT. OF AUSTRALIA 5% 30/10/98	91 1/2	93 1/2	6.34%	Oct. 30
<b>DANISH KRONE DENOMINATED BONDS</b>				
KINGDOM OF DENMARK 8% 20/08/93	97.55	98.30	10.12%	Aug. 20
KINGDOM OF DENMARK 9% 15/11/94	99	99 3/4	9.13%	Nov. 15
<b>ECU DENOMINATED BONDS</b>				
UNITED KINGDOM 9 1/8% 21/02/01	100 7/8	101 5/8	8.83%	Feb. 21
<b>BRITISH POUND DENOMINATED BONDS</b>				
KODM OF SWEDEN 8 3/4% 29/5/96	102 7/8	103 7/8	7.45%	May 29
<b>FRENCH FRANC DENOMINATED BONDS</b>				
CREDIT LYONNAISE 9 1/2% 23/12/96	101 3/4	102 3/4	8.67%	Dec. 23
<b>JAPANESE YEN DENOMINATED BONDS</b>				
WORLD BANK 5 3/4% 7/8/96 RRSP eligible	103.95	104.70	4.37%	Aug. 07
<b>CANADIAN DOLLAR DENOMINATED BONDS</b>				
ONTARIO HYDRO 10 7/8% 08/01/96 (semi annual)	108 1/2	109 1/2	7.69%	Jul. 08
EKSPORTFINANS 7 3/4% 5/11/97	97 5/8	98 3/8	8.16%	Nov. 05
ROYAL BANK OF CANADA 9 1/8% 7/1/97	101 7/8	102 5/8	8.34%	Jul. 7

WE OFFER THE FOLLOWING BONDS SUBJECT TO CHANGE WITHOUT PRIOR NOTICE:

ISSUER/MATURITY DATE/COUPON	BID	OFFER	CURR. ANN. YLD. TO MTY.	NEXT PAYMENT DATE
<b>NEW ZEALAND DOLLAR DENOMINATED BONDS</b>				
TOURIST HOTEL 0% 04/06/93	95.40	96.50	6.07%	4/6/93
<b>SOUTH AFRICAN RAND DENOMINATED BONDS</b>				
ESCOM 11% 31/10/93 (semi)	99	100	11.30%	Oct. 30
<b>AUSTRALIAN DOLLAR DENOMINATED BONDS</b>				
COMMONWEALTH BANK OF AUSTRALIA 14% 01/07/94	109 1/2	110 1/2	7.21%	Jul. 07
<b>ARGENTINE PESO DENOMINATED BONDS</b>				
ARGENTINA BIC V FIXED/FLOATING 1/05/2001 callable in full on any interest date	89.89	90.64	20.21% IRR	4th day of mth.
<b>U.S. DOLLAR DENOMINATED FIXED CONV. BONDS</b>				
DATAPoint CORP. 8 7/8% 1/6/06	60 1/2	63 1/2	15.93%	Dec. 01
CV @ \$18.11 p/hh (semi)				
COOPER CO'S 10 5/8% 01/03/05 (semi)	85			Mar. 01
CV @ \$27.45 p/hh callable in 1995				
DICEON ELECTRONICS 5 1/2% 1/3/12 (semi)	37	40	15.75%	Mar. 01
CV @ \$39.50 p/hh				
BURNUP & SIMS 12% 15/11/00 (semi)	87	90	14.61%	Nov. 15
CV @ \$16.79 p/hh				
ATARI CORP. 5 1/4% 29/4/02	48	50 1/2	15.62%	Oct. 29
CV @ \$16.31 p/hh				
<b>U.S. DOLLAR DENOMINATED FIXED RATE BONDS</b>				
FARM CREDIT CORP. 7 3/4% 10/06/96 RRSP eligible	107	108	5.25%	Jun. 10
REPUBLIC OF ARGENTINA 7/10/93 11% (semi) 1 yr. put	102 1/2	103	7.76%	Oct. 07
<b>U.S. DOLLAR DENOMINATED FLOATING RATE NOTES</b>				
UNITED KINGDOM 24/09/96				Sep. 30
3 mo. LIBID-1/8 (qly)*callable @ 100	99.66	99.96	3%	
REPUBLIC OF ITALY 30/04/93				Oct. 31
3 mo Limean (qly)	99.50		3 11/16%	

HOTLINE UPDATE

**Flash update, Tuesday, September 15:**  
Cover deutschemark, Japanese yen, EMS, and EMS-related currencies at the market. Dec. deutschemark currently trading at 6680.

**Tuesday, September 15:**  
This is a repeat of the flash update this morning. We covered Swiss franc, Japanese yen, EMS, and EMS-related currencies. The deutschemark was done at 6690. The market letter is in the mail.

**Friday, September 18:**  
This is a review of recommendations for the week.  
On Tuesday, Sept. 15 we flashed to cover Swiss franc, Japanese yen, EMS, and EMS-related currencies. The deutschemark was done at 6690. There are no other changes or new recommendations.

**Tuesday, September 22:**  
There are no changes or new recommendations.

**Friday, September 25:**  
This is a review of recommendations for the week. There is one new recommendation. Take advantage of cheap option premiums, purchase at the money put options in deferred months in crude oil. More aggressive accounts can also go short crude oil: place stops at 2300, basis December, close only. The next Hotline Update will be on Wednesday, Sept. 30.

**Wednesday, September 30:**  
There are no changes or new recommendations. There will be a complete update on Friday October 2.

**Flash update, Friday, October 2, 9:30 a.m.:**  
Sell December deutschemark at the market, currently trading at 6910.

**Friday, October 2:**  
This is a review of recommendations for the week. Today, Friday October 2, via flash update at 9:30 am, we recommended to sell December deutschemark at the market, trading at approximately 6910; place initial stop at 7150, close only. And also we recommend to sell March Eurodollar at the market, placing stop at 9730, close only.

**Flash update, Monday, October 5, 10:35 a.m.:**  
Cover short December deutschemark at the market, currently trading at 7100, cancelling previous stop at 7150, close only.

**Tuesday, October 6:**  
There is one new recommendation. Lower the stop on short Canadian dollar to 8010, close only.

**Friday, October 9:**  
This is a review of recommendations for the week.  
On Tuesday, October 6, we recommended to lower the stop on short Canadian dollar to 8010, close only. There are no other changes or new recommendations. The next Hotline Update will be on Wednesday, October 14.

**Wednesday, October 14:**  
One new recommendation: Cover short Canadian dollar futures position and liquidate long put options at the market, cancelling the previous stop of 8010, close only.

**Friday, October 16:**  
This is a review of recommendations for the week. Thursday's opening, October 15, we covered short Canadian dollar futures position at 7955 and liquidated long put options positions. There are no other changes or new recommendations.

**Friday, October 23:**  
This is a complete summary since our last market letter dated September 13 of all liquidations of open positions and new recommendations that remain outstanding.

On Tuesday Sept. 15, we liquidated short deutschemark, EMS, and EMS-related currencies at the market. On Friday, Sept. 25, we advised the purchase of at-the-money put options in crude oil, while more aggressive accounts were advised to short crude oil. March crude oil was then trading at 2134.

Friday, Oct. 2, we advised selling March Eurodollar, then trading at 9688. On Wednesday, Oct. 14, we advised liquidating short Canadian dollar positions and Canadian dollar put options. December Canadian dollar was trading at 7955.

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