FRIEDBERG'S
COMMODITY & CURRENCY COMMENTS
Friedberg Commodity Management Inc. Volume 13, No. 11 December 20, 1992

Canada's inexorable debt crisis

In his 1986 budget papers, former Finance Minister Michael Wilson observed that the federal government could not accumulate debt forever and cited one particularly prophetic reason why it might be risky to try:

"In a situation where real interest rates continuously exceed real economic growth, the fiscal situation can become potentially explosive. In such circumstances, debt and interest payments as proportions of GDP rise without limit.

"The only recourse for the government is to take corrective action and reduce program expenditures and/or raise revenues. The size of the corrective fiscal policy action, moreover, is related directly to both the size of the debt-to-GDP ratio and *the differential between real interest rates and real GDP growth.*"

This text is relevant now because it provides a quick and easy test to measure Ottawa's fiscal situation. By the Finance Department's own criteria, do we have the prerequisite conditions for fiscal explosion or do we not?

1. Canada's short-term interest rates exceeded real GDP growth in 1986 and in every year since. Economists expect this gap to persist through 1996, which is as far out as anyone cares to guess. Canada's real-interest, real-growth gap would appear to meet the necessary condition of "continuous" divergence.

In 1986, real-interest rates exceeded real growth by three percentage points. In the years since, the gaps have increased inexorably from a modest 0.9 in 1987 to 8.5 in 1990 and 8.7 in 1991.

2. Canada's federal debt as a percentage of GDP has risen, through this period, at a progressively fast clip. In 1986, the federal debt ($250 billion) equalled 50% of GDP ($500 billion). In 1987 it rose to 51.2%; in 1988 to 51.4%; in 1989 to 52.3%; in 1990 to 54.7%; in 1991 to 60%. In 1992 the federal debt ($440 billion) will equal 66% of GDP ($665 billion).

So far, so good. The real-interest, real-growth gap does exist; the national debt-to-GDP ratio has behaved precisely as the Finance Department warned. Now we can evaluate the government's "corrective" program of deficit-restraint, remembering that — to reverse things — the correction requires an act of restraint proportionate to the gap between real interest rates and real growth rates.

Mr. Wilson did restrain "program expenditures," and he did raise taxes. In fact, he did so annually. As a result, program expenditures have fallen from 110% of government revenue to 90% of government revenue, an achievement Ottawa often cites as proof of its tough decisions. At the same time, federal revenues have increased by 86%, or almost double the growth in GDP.

Conclusion: Ottawa's expenditure-reduction program and its tax-increase program, in combination, have merely funded the increases in the cost of servicing the government's spiralling debt. Debt-service costs have doubled in current-value terms during the eight years of Conservative "restraint," from $20 billion a year to $40 billion; increasing annually at a double-digit rate (on average, three times the rate of inflation), they now command 33% of all government revenue.

To meet the requirements listed in the Finance Department's 1986 formula, Ottawa must reduce its spending or increase its revenues by an amount large enough to reverse

In this issue

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the debt-to-GDP spiral. To illustrate the magnitude of restraint necessary to meet this test, assume that the government reduced its 1993 deficit to zero; further, that GDP grew by a real 3%; further, that real interest fell to 3%. Under these circumstances, the debt-to-GDP ratio would fall from 66% to 65%, and the spiral would end.

This fantasy makes very clear the dimensions of Canada's fiscal crisis, and provides a dramatic backdrop to Finance Minister Don Mazankowski's early-December emergency budget. If there is solace for the markets in Mr. Mazankowski's sober numbers, it is the kind Shakespeare spoke about: "The worst is not,/So long as we can say,/'This is the worst.'"

If not the absolute worst the markets could expect, Mr. Mazankowski's retreat from what was necessary was starkly inadequate. The 1983-84 deficit will be $32.6 billion, or $10 billion more than the finance minister anticipated as recently as February. And the consequence of this for out debt-to-GDP ratio? In 1993-94, Canada's national debt will rise to 72% of GDP.

On the eve of an election year, Canada has effectively postponed action on its debt crisis for a year and a half. Conservative strategy is to give the markets rhetorical assurance of future fiscal responsibility (beginning in 1994) and to ask for patient understanding in the meantime. Do the markets really want the Liberal or NDP alternatives? The proposition, however, is only marginally seductive. The fiscal crisis is apparent to everyone; even the socialist NDP responded to Mr. Mazankowski's budget with the declaration that government spending "cannot be sustained."

And for how long can the Conservatives expect the markets to wait around for action anyway? Assuming that the Conservatives won a return to power next fall, the subsequent 1994 budget could — at best — merely set decisive restraint in motion. The procrastination policy requires equivalent patience from the markets and from the electorate from now until 1996 for evidence of results. In real-life terms, this is roughly the same as waiting till Doomsday. Without some form of divine intervention, the debt-to-GDP ratio will have by then approach 100%.

In August, foreign investors ended a passionate two-year dalliance with Canadian securities. While the romance lasted, foreign investors moved more than $60 billion into Canadian bonds and other money market investments. In August, they reduced their holdings by a net $4.7 billion. (In September, they were net sellers of another $330 million.) The August reversal was the largest ever; and it included the dumping of $4 billion in Canadian bonds, most of them federal issue.

Canada is crucially dependent upon foreign investors to buy its debt and to hold on to it. They now hold $280 billion of it. But the Japanese started to sell off their holdings last year; now the Americans are selling off as well (by a net $2 billion in August alone).

In his emergency budget, Mr. Mazankowski said only that the government would cut $7.5 billion from its *projected* increase in spending over the next 30 months. Further, he erected his analytical framework on a foreign assumption — that the provinces will not increase their own deficits. (Ontario has already declared that it will do both of these things.) In combination, Ottawa and the provinces will be putting more than $50 billion of debt for sale next year — when, as Mr. Mazankowski himself observed, they have passed the limit on their credit cards.

Who — Canadian or foreign — will be prepared to assume the rising risks of this debt? And at what price will they do it? To invoke Shakespeare one more time, Canada's debt crisis looks and sounds "more inexorable far than the roaring sea."

– Neil Reynolds

STRATEGY: *Fearful of rising taxation, capital will continue to flee. Remain short; lower stops to 78.45, basis March '93, close only.*

US DOLLAR

Defining its strength

The logic of a stronger dollar has not eluded global money managers. In fact, they have reacted in herd-like fashion: A Merrill Lynch survey reports that since September, 71% of the 84 investors polled are overweight dollars, up 50% from September. When combined with the 20% managers who are neutral, 91% are said to be either content or bullish with the US dollar. The 9% underweight (read "bearish") is the lowest underweight exposure since the survey was initiated (see Chart 1).

Of course, the bullish case is simple (we developed it in detail in our September issue in an article entitled "Paradise lost: on the decline of Europe and what it means for the dollar"). The US economy is in an upswing while Europe is in the midst of a slump that looks to become meaner. Ergo, cyclical considerations argue for a stronger dollar, which, at any rate, is quite cheap (we are abstaining from calling it undervalued, as this would imply much greater theoretical precision than warranted).

Well, what's wrong, then, with the consensus view? Nothing, except that the argument only leads to two conclusions: a) the *trade weighted* US dollar will recover in *real* terms, and b) the recovery will take place in the long run.

The first conclusion can be satisfied via a rise in the nominal exchange rate or alternatively via a rise in differential inflation rates accompanied by little or no nominal appreciation (or even a fall).

Further, one would have to pay special attention to the trade-weighted dollar as more and more currencies withdraw from the ERM or an ERM related peg. In other words, and contrary to popular belief, the DM/US dollar relationship is no longer the key exchange rate to focus on when assessing the broader direction of the US unit.

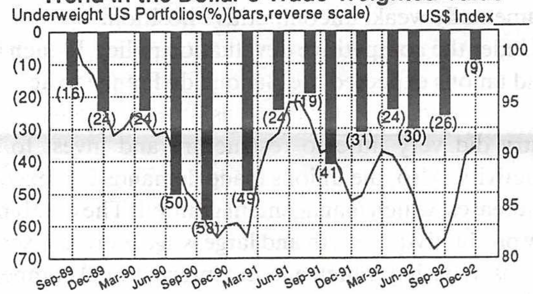
On the second point, a recent study (*Is Purchasing Power Parity a Useful Guide to the Dollar?* Federal Reserve Bank of Kansas IIIQ1992) concludes that "purchasing power parity is a useful *long-run* guide to the dollar. With the dollar currently estimated to be about 20% below its PPP value against the DM and yen, the dollar is likely to rise against these currencies *over the next several years.*"

It also found that PPP is less useful as a short-run guide to the dollar, "only when deviations from PPP are *unusually large* is the dollar more likely to move toward PPP than away from PPP in the short run... as a result, while the value of the dollar is likely to rise over the next few years, the dollar's outlook over the near term remains uncertain."

In short, a short-term to medium-term trading strategy designed to capitalize on the seeming inevitability of a rising dollar is not quite as simple as it sounds. On a trade-weighted basis the dollar will continue to firm as European currencies are taken out of the ERM peg and shot, and as various other currencies such as the Canadian dollar follow their own downward path. This suggests too that the D-mark, the Swiss franc, and later on possibly the yen may be the wrong currencies to play the bullish dollar scenario.

Furthermore, as we have stated in the past, the nominal value of the US dollar need not rise so long as US inflation exceeds that of its trading partners by a margin of a few percentage points per annum.

Chart 1



Currency & Bond Market Trends

DEUTSCHEMARK

The uncharted voyage continues

On a very near-term basis we continue to believe that the US dollar, at least *vis à vis* the D-mark and Swiss franc, is overbought and overextended. In the face of serious domestic inflationary pressures — nontradeable goods and services are rising at 7% to 8% per annum — the Bundesbank remains absolutely firm, oblivious to worldwide pressure to relent and clearly aware of the added dangers of a depreciating D-mark.

As posited in our March 15 issue ("A journey into the unknown"), at reunification Germany entered into an uncharted monetary voyage, the consequences of which will be with it for a long time to come.

STRATEGY: *We are long D-mark against the dollar, against the French franc (see separate article and Hotline Update Dec. 8), and against the yen (Hotline Update Nov. 30). Place stops at 6108, basis March '93, close only. Against the yen, place stops at 76, basis March '93, close only.*

We are also short March '93 Bunds traded on the LIFFE at approximately 9160 with stops at 9195, close only, and March '93 Euromarks, also traded on the LIFFE at 9204, risking 9230, close only.

Chart 2
CME DEUTSCHE MARK MAR '93

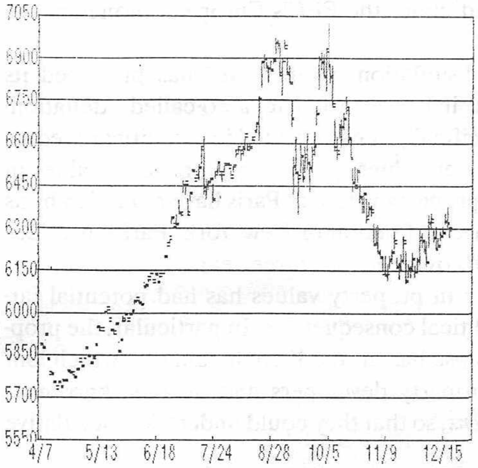


Chart 3
LIF GERMAN GB MAR '93

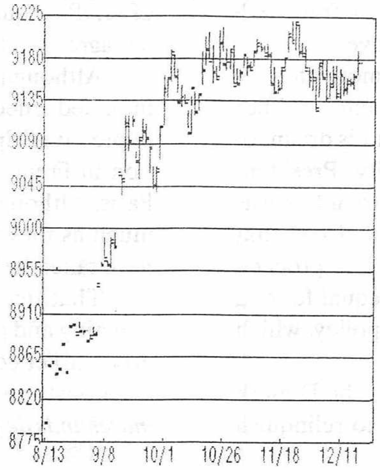
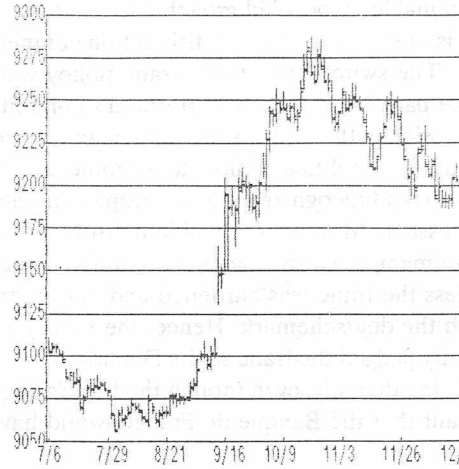


Chart 5
LIF EUROMARK MAR '93



CURRENCIES

Demise of the franc fort

The French franc policy that characterized most of the 1970s and early 1980s was one of "competitive devaluations." Whenever French exports sagged, the Banque de France allowed the franc's exchange value to slide, in an attempt to boost exports and stimulate the economy. That strategy didn't bear much fruit. Indeed, it backfired, leaving French industry in a fundamentally weak, uncompetitive position.

Under the competitive devaluation policy, French industry and unions expected the Banque de France to accommodate their requests for devaluations. In consequence, French industry did very little to restructure and invest to boost productivity. Also, the unions made demands for "excessive" pay increases, which management granted. The combination of low productivity growth and large wage increases sent unit labor costs soaring, which cut into international competitiveness. In order to reduce the pain, French industry and unions demanded and received temporary relief via devaluations.

That is not the end of the story, however. The franc policy has other ramifications. It resulted in relatively high inflation and interest rates. Moreover, it almost destroyed the Banque de France's credibility, which caused a devaluation risk premium to work its way into French interest rates. Those high interest rates ultimately acted as a drag on the French economy. On balance, therefore, the "competitive devaluation" policy was a bust. It ratified economic agents' inflationary wage and price setting and contributed to slow, uncompetitive growth and endemic unemployment as well as lax management and unruly union behavior. To illustrate this point, consider that it was not until 1988 that France's civilian employment regained its 1974 level.

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In late 1986, the French government switched gears and fully embraced a strong franc policy: the *franc fort.* The objective of the *franc fort* was to push French inflation rates below those of it major trading partners, in order to stimulate sustainable, export-led growth. Hence, the strong franc policy is often referred to as "disinflation competitive."

The switch to a strong franc policy was motivated, in large part, by President Mitterrand's commitment to, if not obsession with, a European political union. For his dream of creating a political union to become a reality, President Mitterrand recognized that a European monetary union was necessary. Moreover, President Mitterrand realized that movement towards a monetary union could not proceed unless the franc was hardened and put on an equal footing with the deutschemark. Hence, the *franc fort* policy, which tightly pegged the franc to the D-mark.

Incidentally, even though the franc's peg to the D-mark meant that the Banque de France would have to relinquish French monetary policy to the Bundesbank, the Banque was quietly supportive of the new policy. Indeed, shortly after the *franc fort* policy was instituted, I delivered a lecture at the Banque de France, and officials explained their position to me.

They indicated that the French unions were so strong that there was little chance that, lacking a peg to the D-mark, the Banque could institute a credible, independent monetary policy. For example, a switch from "competitive devaluations" to monetary targeting would not have been feasible because the unions would always demand and receive pay increases that exceeded any monetary targets announced by the Banque. Hence the Banque endorsed the peg because it thought the peg would allow the Banque to control inflation and eventually regain some credibility.

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The results of the *franc fort* have generally been quite impressive. In consequence, the OECD was able to conclude, in its most recent *Economic Survey* of France, that "the unemployment problem apart, however, the economic fundamentals are in good shape. France suffers from no major disequilibrium which could prevent a recovery from taking place in the near future. The household sector is not unduly indebted by international standards. Firms have weathered the phase of stagnating demand with a much smaller loss of profitability than occurred earlier in the 1980s, liquidity is adequate, and balance sheets appear to be healthy overall. While inflation has remained stable, competitiveness continues to improve, as increases in wages and prices have been kept below rates in most other countries. The result has been a fairly marked recovery in export performance and a reduction in deficits on both the merchandise-trade and current accounts."

Indeed, France, from a macroeconomic point of view, is fundamentally the strongest economy in Europe, and one of the few European economies that could meet the convergence criteria (inflation, fiscal deficit, and debt as a percent of GDP) required under the EEC's European monetary union agreement.

Although "disinflation competitive" has produced its intended effects, it has also led to a so-called "deflation-depressive." Specifically, it has resulted in a significant reduction in French asset values, particularly property values in Paris. Although property values in Paris have not fallen by as much as they have in London or New York, Parisian values have fallen by 20% over the past three years.

That decline in property values has had potential far-reaching and political consequences. In particular, the property market collapse has hit the French banks — which lent generously to property developers and dealers, known as *marchands de biens*, so that they could undertake speculative commercial property deals in Paris. For example, the banks have FFr400 billion to FFr500 billion in outstanding real estate loans, and at least 20% are so doubtful that the banks should be making provisions against them. Indeed, at present, the commercial court of Paris is dealing with 15 cases of large property developers and *marchands de biens* facing bankruptcy or other financial crisis.

The banks have been scrambling to deal with their bad loans. They have been provisioning. For example, the banks have provided provisions for about half of their bad real estate loans. However, given that the entire French banking system made a net profit on only FFr11.1 billion last year on its domestic business, a full provisioning would wipe out many of the banks' profits, if taken in a single year. In consequence, some banks have been forced to convert property loans into equity, which is held by their own property development subsidiaries. The banks have also required new capital infusions. For example, in December alone, Compagnie Financière Suez pumped FFr2.36 billion new capital into Indosuez and Credsuez, two of its banking subsidiaries, and Union des Assurances de Paris injected FFr1.4 billion into Banque Worms, its banking unit.

Insurance companies, heavy investors in Parisian commercial property, have also been hard hit by the "deflation-depressive." Indeed, it is alleged that they are so desperate that they have engaged in some, to put it mildly, questionable practices. Specifically, they have apparently been exchanging property investments between each other at "high" prices, so as to "prop up" property values and "strengthen" their balance sheets.

Not surprisingly, the state of the Parisian property market has motivated the property developers and *marchands de biens* to ask the government for a bailout. That request fell on deaf ears. The Socialist prime minister, M. Pierre Bérégovoy, indicated that he didn't want to do anything that could be interpreted as bailing out property speculators. However, earlier this month, the banks and insurance companies sent an SOS message to the government. That request for a property-specific bailout was received with "an attentive and understanding ear." To date, the government has not taken any property-specific bailout action.

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That brings us back to *franc fort.* In addition to deflating asset values, that policy — particularly given the way it has been implemented — has squeezed the banks from another, nonproperty angle. The franc's peg to the D-mark has caused short-term money-market interest rates to rise above the domestic prime lending rate because the government has used "moral suasion" to force banks to keep a lid on lending rates. Indeed, under speculative pressure on the franc, the gap between short-term money rates and prime lending rates has approached 5%.

That method of defending the franc cannot be sustained, however, as it cuts deeply into bank profits. Indeed, last week, the banks finally began to play hardball with the government. After Moody's downgraded its ratings of Banque Nationale de Paris and Credit Lyonnaise, the banks threw moral suasion to the wind, and increased their prime rates more than half a percentage point to 10%. Given that annual inflation eased further from 2.4% in October to 2.1% in November and that unemployment is 10.4% and rising, that increase in lending rates got the government's attention. It also bought out the critics of the *franc fort* who argued that that policy was inappropriate in light of the sluggish record of output increases over the past two years, the ensuing increase in unemployment, the high real rates, and of course, the collapsing asset values.

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IMPLICATIONS: Until last week, the only serious voice raised in favor of realignment of the franc peg with the D-mark had come from Dr. Helmut Schlesinger, President of the Bundesbank. Dr. Schlesinger had grown tired of having to pump out D-marks to prop up the sagging franc. After all, he is trying to rein in the exploding D-mark money supply, and Bundesbank intervention to support the franc makes that task more difficult.

Last week, however, M. Alain Madelin — a rising star in the Union pour la Democratic Française party (UDF) — called for a floating franc and lower French interest rates. This was a significant event, because the UDF is a major opposition party and because it opens up the French political debate about the *franc fort*, something that had been kept under wraps.

We anticipate that the debate will continue to heat up, because property developers and *marchands de biens* are traditionally large contributors to French politicians. Hence, M. Madelin will probably find some political support for his cause. As the political warfare gains momentum, the speculative sharks will continue their feeding frenzy over the franc. That will, no doubt, not please Dr. Schlesinger. Given that a floating franc would deal a devastating blow to Messrs. Mitterrand's and Bérégovoy's credibility and dreams of a European monetary union, it is doubtful that the French will float. However, there is a real chance that the Germans and French will join hands in a realignment of the ERM, one that is done so that the French can save face and give the impression that they are retaining their *franc fort* policy.

– Dr. Steve H. Hanke

STRATEGY: *We are short French franc against DM at a cross of around 3.4050 as per Hotline Update. This trade is made possible by the perversity caused by the ERM, which allows speculators to take risk-free shots at the expense of the Bundesbank. Favorable underlying fundamentals, however, will probably support a bounce of the franc after either a float or, what is more likely, a realignment, as we do not anticipate a lowering of interest rates in excess of 150 basis points.*

CURRENCIES

Italy: A political D-tour

Still reeling from the huge but expected electoral losses suffered at the hand of voters in 55 communities across the country, Italy's coalition Amato government took another blow when Milan magistrates notified Socialist leader Bettino Craxi that he was under preliminary investigation in connection with a corruption scandal.

Since Craxi was Amato's mentor and the head of his party, doubts began to surface about the durability of what looked like Italy's best and most straightforward post-war government. The silver lining in this affair is that the established parties, bereft of scandalous political contribution, are in no shape to call another election, while the new parties like the Northern League, the Italian Social Movement, and the Network are not yet strong enough to topple the government.

As long as Amato is not touched personally — and there is nothing to lead anyone to believe that there are skeletons hidden in his closet — he may be able to use the crisis as a smokescreen to pass all the proposed reforms, and perhaps a few new ones along the way.

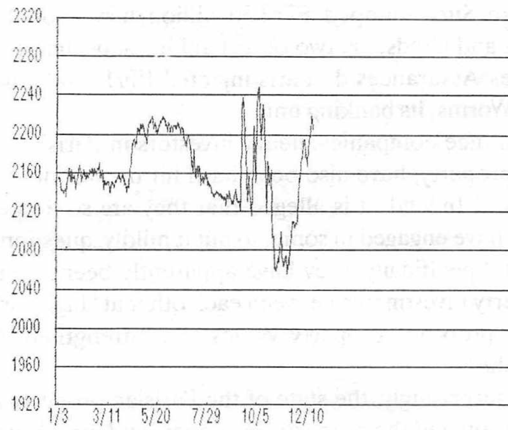
By the middle of January, we should know whether he has fully succeeded in his ambitious venture, including the most dramatic government divestiture/privatization program anywhere in the Western world.

At the same time, the Brits are likely to lower once again the base rate in view of the most recent M4 and lending figures (see United Kingdom for more details), which should weaken the Sterling/D-mark cross.

The present political turmoil in Italy may either present a unique opportunity to cash in on a genuine once-in-a-generation turnaround or significantly deplete our trading account as chaos ensues. We are inclined to the former, as we believe in the man and we believe in the forces that are propelling change; they are not likely to be d-toured by the remnants of a corrupt political order. With it all, you will need nerves of steel. And a prayer.

STRATEGY: *Remain long Italian lire against short Sterling initiated last month at LIT2178 per Sterling on a six-month forward contract.*

Chart 6 – LIRA PER £



UNITED KINGDOM

Bullish on FTSE 100

Just when faint signs of recovery were appearing on the horizon, such as the expansion of retail sales volume by 0.9% in the three months to the end of October, the country was hit by an unexpected 0.2% drop in M4 for the month of November and an increase of 4.7% in the 12 months to November, well below expectations of 0.4% growth on the month and a 5.4% expansion year to year.

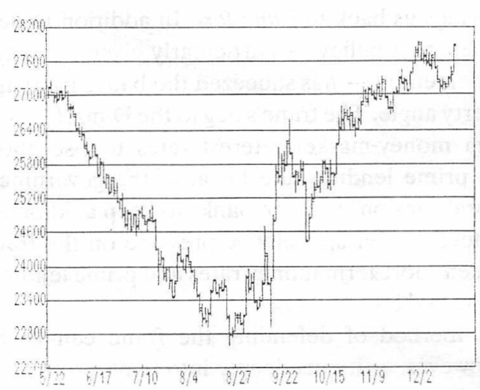
M4 paralleled the weakness in lending, which saw a seasonally adjusted increase of £572 million last month after an increase of £3.05 billion in October. Taking the past three months together, bank and building society lending has grown by only £1.2 billion a month, which is the lowest rate of increase since the figures were first collected in 1982.

While these figures may be disappointing to the policy makers, as they point to a very weak recovery and a long unwinding of the massive debt hangover of the '80s, they were clearly music to the share market. They signify lower rates against the background of rising productivity and rising corporate cash flow. And best of all, from a starting point where the return on shares — earning yields of 6% — easily exceed real returns available on index and non-index gilts.

We remain very bullish on the FTSE 100.

STRATEGY: *Remain long nearby FTSE 100 futures. Place stops at 2695, basis the cash index, close only.*

Chart 7 – FTSE 100 INDEX SPOT



INTEREST RATES

Double digits on the horizon

The potential for a future explosion in inflation becomes ever more real. Adjusted reserves and narrower monetary aggregates continue to rise rapidly: The first at a 28.7% annual rate, the second at a 20% pace measured over the past two months.

At the same time, with an overall improvement of the economy, commercial banks' total loans have begun to recover: September saw an annualized increase of 6.6%, the first increase in four months and the first increase of such a magnitude since *August 1990.* Significantly, in September 1992, total year-to-year bank loans had stopped falling — for the first time since July 1991. The so-called credit-crunch is over.

As we've pointed out in previous issues, an increase in bank loans will easily be accommodated via a liquidation of bank investments in securities. This will tend to quickly put upside pressure on interest rates, *regardless of Fed actions.*

At the end of September 1992, banks held $810 billion in investments (primarily US government obligations), a staggering $107 billion more than last year at this time and $180 billion more than two years earlier. The reversal of this investment-accumulation/loan-liquidation process will be the single most important factor behind the coming rise in interest rates. It also promises to become a growing problem for the Fed, which has virtually lost control over the expansion of credit, at least in the medium term.

T-bonds have been acting better, encouraged by President-elect Clinton's pledge to reduce the deficit. Weakness in oil prices may have also played a role. Regardless of these factors, inflation and the accommodation of future loan demand will drive long-term interest rates to double digit levels by late 1993/early 1994.

STRATEGY: *We were stopped out on our March '93 Eurodollar short positions when it closed at 93.31, producing respectable profits. Stand aside. Retain long positions in September '93 T-bond put options.*

S&P 500

A top in the offing

Last September we correctly anticipated the current upswing based on the fact that sentiment had become too negative. Among other things, we pointed to a very low bullish consensus (five weekly readings of 25% or less) and the *virtual death* of the IPO market as indicative of a market lacking the normal exuberance shown at tops. We also suggested that it was not generally perceived that the economy's upswing was solidly based and that therefore such an event cannot be overdiscounted.

We concluded that this powerful combination of solid but unrecognized fundamentals and very negative sentiment should produce an explosive market rally. In October and November we reiterated our view that stock prices were breaking out on the upside and warned that a January blow-off was a good possibility.

As the current red-hot IPO market suggests, sentiment has swung far and wide. And the perceptions about the economy have changed so materially that even President-elect Clinton has begun to move away from fiscal stimulus to fiscal austerity.

Timing a top has always been extremely tricky. All the more so when it involves picking a top to a never-ending 18-year bull market, perhaps the longest such bull market in US history. Common stocks have been an excellent investment for so long that an equities cult has been created. Which gives rise to the paradoxical observation that the higher prices rise, the more they are likely to rise. While picking *the* top, therefore, is either a matter of luck or prophecy, picking a top that, in retrospect, may later be recognized as *the* top, may be a little easier.

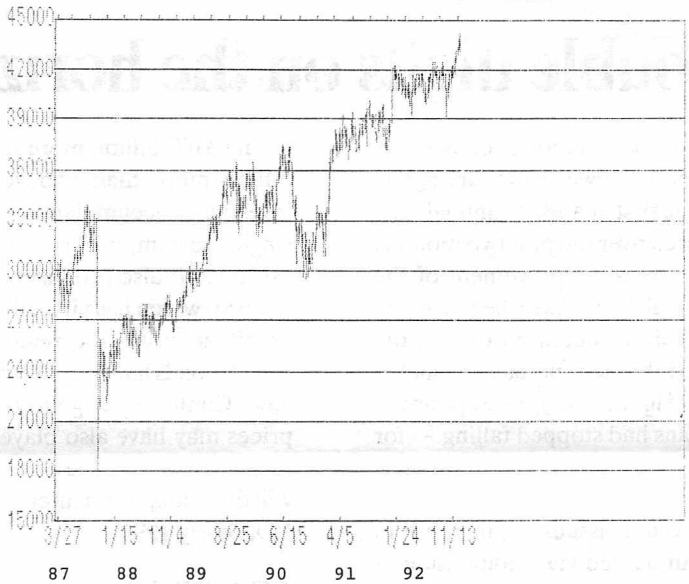
Late December 1992 is becoming a mirror image of August/September 1992: The economic expansion has become apparent to nearly everyone and sentiment has turned bullish to rampantly bullish (depending on who you ask and what you look at).

Although dividends and earnings have increased somewhat over the past 12 months, this market is being sustained primarily by cheap money. And money will remain cheap until we begin to see a rise in total bank loans. That process may have already begun (see our discussion on interest rates).

In conclusion *a* top of sorts is in the offing. The ideal time may be just before the release of fourth quarter earnings, which should begin to stream in January 7 to 10. This, coincidentally, is only days away from President-elect Clinton's first State of the Union address. Too much misplaced hope may have been laid on both events.

STRATEGY: *Remain long S&P 500 futures and/or options. Be prepared to bail out at the end of the first week in January.*

Chart 8 – CME S&P 500 INDEX



COMMODITIES

Sugar

Despite the many efforts brokers and newsletter writers made all through 1991 to manufacture excitement, we have to conclude that, ultimately, it has been a dreadfully dull year!

The CRB (Commodity Research Bureau) opened at 209.70 on January 3, the first trading day of 1992. It closed December 18, the final trading day before this, our last publication of the year, at 204.00; a loss of a full 2.7% The range — from a high of 216.30 (in February) to a low of 198.25 (in October) — was less than 9% of the lesser value; surely the least volatile since the break-up of the Bretton Woods system of fixed exchange rates in 1972.

Buyers of puts and calls have been bloodied. Our managed Options Accounts are licking wounds.

What for 1993? My prognosis is for higher commodity prices.

Here are my reasons:

1. The ratio of the CRB index to the Dow, i.e., of hard assets to financial assets is at lows never seen before in history.
2. We believe we are in for a hefty dose of inflation, the effects of which will appear significantly larger than they would otherwise because of the shock inflation is likely to have on a market that is currently extremely complacent about the phenomenon.

You could have made these arguments last year at this time too. That being the case, we must admit that, though we conclude we will see higher prices, we must be somewhat phlegmatic regarding timing.

Since October, we have begun establishing a portfolio of futures positions — not options, which impose a timing imperative upon the investor — that:

- are cheap relative to their historic values,
- have reasonable fundamentals and equally reasonable possibilities for error on the bullish side of the fundamental ledger,
- have technical conditions that can, at the very least, orient us toward an exit if we are wrong in our optimistic mappings.

So far, our portfolio consists of cocoa, silver, and corn. To these we now advise adding sugar.

In many ways sugar is as much a barometer of aggregate commodity prices as any single commodity on the board. The most volatile of commodities during the volatile '70s, its tranquillity this past year mirrored, virtually perfectly, the CRB. March '93 sugar opened the year at 840 and closed Friday at 830.

The 1992-93 crop year, which began Oct. 1, is forecast to register a small surplus of between .5 mln tonnes and 1.0 mln tonnes. The surplus will leave inventory as a percentage of usage at the same level as it was when the year started.

A disproportionate share of world stocks sits in India. The world's largest producer has been experiencing a tremendous oversupply problem due to government subsidies to sugar mills. Since it is the world's largest producer of sugar and therefore the country most vulnerable to a further decline in prices, it is unlikely India will dump its inventory on a market many — not us — consider fragile.

The tip of the fundamental scales may come from India, which will undoubtedly reduce agricultural inputs and may establish a buffer stock at the same time. Or it could come from Eastern Europe where consumption has been predicted lower but, because of the lack of reliable statistical information, is anybody's guess.

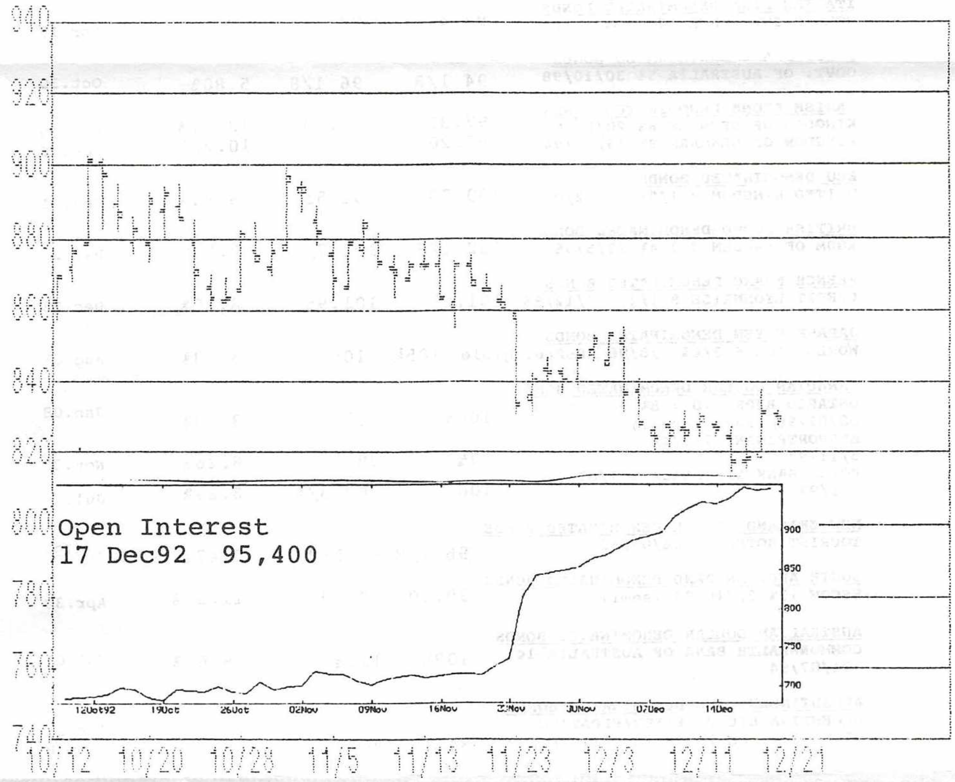
The technical condition of the sugar market is favorable. Chart-wise the risk is clearly demarcated and manageably small. (see Chart 9). And the open interest is filled with promise. My colleague Al Friedberg pointed out to me the other day that he could not recall seeing sugar open interest rise during a falling market; the implication being that funds have been selling the market short with both barrels blazing but yet to no great effect.

Furthermore, Steve Briese in the Dec. 14 issue of his *Traders Commitment Report* points out that the other side of the fund short sales has been taken up by commercials and in record numbers, the implication here being, according to Mr. Briese, that the critical ingredient to a major bull market has been added to the mix.

STRATEGY: *Buy outright March sugar at market with stops at 7.66, the lows of '92.*

– David Rothberg

Chart 9
SUGAR MAR '92



CRUDE OIL

The bear gathers momentum

This past week witnessed the first reaction from a deeply oversold market that has fallen more than $3.60 per barrel from its highs.

As we approach the low-usage spring period, the bear market will gather renewed downside momentum. No country with any significant output is willing to sacrifice present production. The logic is unassailable: Vast reserves in the former Soviet Union, rising exportable surpluses from that region as a result of falling incomes and rising prices, renewed hopes on the cold fusion front, and the ever present electric car possibility make today's production far more profitable than tomorrow's.

Given the choice, you too would pump oil at $13 to $15 per barrel above marginal cost today rather than wait to sell it five or 10 years hence at marginal cost.

STRATEGY: *Remain short via a long position in crude oil put options.*

FRIEDBERG CAPITAL MARKETS

Chart 10

Date: DEC 17, 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				
BANK OF NOVA SCOTIA 5 5/8% 07/05/96 RRSP eligible	92 5/8	93 3/8	7.92%	May 07
WORLD BANK 5 7/8% 4/02/97 RRSP eligible	97.85	98.60	6.27%	Feb.04
WORLD BANK 9% 13/11/00 RRSP eligible	113.15	113.90	6.67%	Nov.13
FINNISH MARKKA DENOMINATED BONDS				
REP. OF FINLAND 11% 15/6/95	100.35	101.10	10.41%	Jun.15
ITALIAN LIRA DENOMINATED BONDS				
NORDIC INV. BANK 12 3/8% 19/04/96	97 5/8	98 3/8	12.94%	Apr.19
SWISS FRANC DENOMINATED BONDS				
GOVT. OF AUSTRALIA 5% 30/10/98	94 1/8	96 1/8	5.80%	Oct.30
DANISH KRONE DENOMINATED BONDS				
KINGDOM OF DENMARK 8% 20/08/93	97.35	98.10	10.81%	Aug.20
KINGDOM OF DENMARK 9% 15/11/94	97.20	97.95	10.22%	Nov.15
ECU DENOMINATED BONDS				
UNITED KINGDOM 9 1/8% 21/02/01	100.80	101.55	8.84%	Feb.21
BRITISH POUND DENOMINATED BONDS				
KGDM OF SWEDEN 8 3/4% 29/5/96	102 1/8	102 7/8	7.74%	May 29
FRENCH FRANC DENOMINATED BONDS				
CREDIT LYONNAISE 9 1/2% 23/12/96	101.20	101.95	8.90%	Dec.23
JAPANESE YEN DENOMINATED BONDS				
WORLD BANK 5 3/4% 7/8/96 RRSP eligible	105¼	106	3.93%	Aug.07
CANADIAN DOLLAR DENOMINATED BONDS				
ONTARIO HYDRO 10 7/8% 08/01/96 (semi annual)	106¼	107	8.39%	Jan.08
EKSPORTFINANS 7 3/4% 5/11/97	97¼	98	8.26%	Nov.05
ROYAL BANK OF CANADA 9 1/8% 7/1/97	100	100 3/4	8.89%	Jul.7
NEW ZEALAND DOLLAR DENOMINATED BONDS				
TOURIST HOTEL 0% 04/06/93	96 7/8	97 5/8	5.47%	4/6/93
SOUTH AFRICAN RAND DENOMINATED BONDS				
ESCOM 11% 31/10/93 (semi)	99.30	100.05	11.20%	Apr.30
AUSTRALIAN DOLLAR DENOMINATED BONDS				
COMMONWEALTH BANK OF AUSTRALIA 14% 01/07/94	109½	110¼	6.61%	Jul.07
ARGENTINEAN PESO DENOMINATED BONDS				
ARGENTINA BIC V FIXED/FLOATING 1/05/2001 callable in full on any interest date	84.19	84.94	25.69%IRR	4th day of mth.
U.S. DOLLAR DENOMINATED FIXED CONV.BONDS				
DATAPOINT CORP. 8 7/8% 1/6/06 CV @ $18.11 p/sh (semi)	64½	66½	15.18%	Dec.01
DICEON ELECTRONICS 5 1/2% 1/3/12 (semi) CV @$39.50 p/sh	37½	40½	15.60%	Mar.01
BURNUP & SIMS 12% 15/11/00 (semi) CV @$16.79 p/sh	85½	89½	14.76%	Nov.15
ATARI CORP. 5 1/4% 29/4/02 CV @$16.31 p/sh	49	51	15.49%	Apr.29
COEUR D'ALENE 6% 10/6/02 CV @$37.655 p/sh	79½	82	8.88%	Jun.10
COEUR D'ALENE 7% 30/11/02 CV @$15.87 p/sh (semi)	98½	100¼	7.09%	May.31
U.S. DOLLAR DENOMINATED FIXED RATE BONDS				
FARM CREDIT CORP. 7 3/4% 10/06/96 RRSP eligible	105.97	106.72	5.55%	Jun.10

U.S. DOLLAR DENOMINATED FLOATING RATE NOTES	BID	OFFER	CURRENT COUPON	
UNITED KINGDOM 24/09/96 3 mo.LIBID-1/8 (qtly)*callable @ 100	99.80	100.10	3%	Sep.30

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
Canada & U.S.A. 1-800-461-2700

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, DKr, BP, FFr, ECU, CD, SAR, ITL, ARG, FIN) or revalue for SF, JY, before the interest rate advantage/disadvantage is overcome by currency depreciation/appreciation. **Rates as of Thursday, December 17, 1992.**

	US. $	NEW ZEALAND $	AUSTRALIAN $	DEUTSCHEMARK	SWISS FRANC	JAPANESE YEN	DANISH KRONE	BRITISH POUND	FRENCH FRANC	EUROPEAN CURRENCY UNIT	CANADIAN DOLLAR	SOUTH AFRICAN RAND**	ITALIAN LIRA	ARGENTINEAN PESO	FINNISH MARKKA
1 year	3.71%	Tourist '93 yields 5.47% (.5195 NZ/US)										ESCOM 11% '93 yields 11.20% (.1919 US/SAR)			
2 year	4.62%		CBA '94, yields 6.61% (.6897 A$/US)				Denmark '94, yields 10.22% (6.641 Dkr/US)								
3 year	5.15%			Bk. Nova Scotia '96 yields 7.92% (1.675 US/DM)									NIB '96 yields 12.94% (1.734 ITL/US)		Finland '95 yields 10.41% (5.904 FIM/US)
4 year	5.60%					World Bk. '96 yields 3.93% (115.04 US/JY)		Sweden 8¾% '96 yields 7.74% (1.465 BP/US)	Credit Lyonais '96 yields 8.90% (5.992 Ffr/US)		RBC '97 yields 8.89% (1.442 US/CD)				
5 year	6.04%										Eksport finans '97 yields 8.26% (1.419 US/CD)				
6 year	6.22%				Australia '98, yields 5.80% (1.357 US/SF)										
8 year	6.48%			World Bk '00 yields 6.67% (1.572 US/DM)						U.K. '01 yields 8.84% (1.06 ECU/US)					
9 year	6.63%													***BIC V '01 yields 25.89% (.2220 US/ARG)	
Spot Exchange Rate	–	.5195	.6897	1.5497	1.390	122.60	5.983	1.5875	5.2975	1.2629	1.2754	.2058	1.399	.9895	5.098

*For example, since a US$-based investor would receive 779 basis points (1294-515) by holding the NIB Italian lira bond, the ITL/US can depreciate to 1.734 ITL/US from the present spot exchange rate of 1.399 ITL/US over the next 3 years for the ITL investment to break even with current US$ 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.

***yield is actually internal rate of return (IRR)

Recommended bond portfolio allocation for new portfolios

For new portfolios, we recommend the following investments:

Finnish Markka fixed rate bonds	15%	Argentina BICV	22%
Italia Lira fixed rate bonds	25%	US $ Floating rate Notes	13%
US $ high yield CV bonds	25%		

HOTLINE UPDATE

Tuesday, November 24:
There are no changes or new recommendations.

Friday, November 27:
There are no changes or new recommendations.

Flash update, Monday, November 30:
There are three new recommendations:

1) Sell March LIFFE German bonds at the market, risking 9195, close only.
2) Sell March LIFFE Euromarks at the market, risking 9230, close only.
3) On a spread, buy DM and sell Japanese yen at the market on an equal dollar value.

Tuesday, December 1:
This is a repeat of the flash update on Monday November 30.

First, we sold March German bonds traded on LIFFE at approximately 9160, risking 9195, close only. Second, we sold March Euromarks traded on LIFFE at approximately 9204, risking 9230, close only. Third, we bought March D-mark and sold March Japanese yen as a spread in equal dollar value at approximately 7722 cross. There are no other changes or recommendations.

Flash update, Friday, December 4, 10:00 a.m.:
Sell long March D-mark positions at the market, presently trading at 6177, cancelling the stop close only at 6110.

Friday, December 4:
This is a recap of recommendations for the week. On Tuesday Dec. 1 based on the flash update of Monday Nov. 30, we sold March German bonds traded on LIFFE at approximately 9160, risking 9195, close only. Also we sold March Euromarks traded on LIFFE at approximately 9204, risking 9230, close only, and we bought March D-mark and sold March Japanese yen as a spread, in equal dollar value at approximately 7722 cross. On Friday, Dec. 4, we sold long March D-mark positions at approximately 6177 as per flash update at 10:00 a.m., cancelling the stop close only at 6110.

Tuesday, December 8:
Lower stops on March Canadian dollar to 7845, close only, basis March. There is one new recommendation. In our opinion the French franc is about to be dropped from the ERM; therefore, sell French franc against the purchase of marks for three months' maturity.

Flash update, Wednesday, December 9, 2:30 p.m.:
Buy March D-mark at the market, presently trading at 6279.

Friday, December 11:
This is a recap of recommendations for the week. On Tuesday Dec. 8, we advised to lower stops on Canadian dollar to 7845, close only, basis March, and to sell French franc, which in our opinion will be dropped from the ERM shortly, against the purchase of D-marks for three months' maturity. The spot cross was 3.4050. On Wednesday Dec. 9, via flash update we advised the purchase of March D-mark, then trading at 6279. We now advise to place a stop on the D-mark at 6108, stop close only, basis March.

Tuesday, December 15:
There are no changes or new recommendations.

Friday, December 18:
This is a complete summary since our last market letter dated Nov. 22 of all liquidations of open positions and new recommendations that remain outstanding.

On Tuesday, Dec. 1, via flash update of Monday, Nov. 30, we sold March German bonds traded on LIFFE at approximtely 9160, risking 9195, close only, and sold March Euromarks traded on LIFFE at approximately 9204, risking 9230, close only. In addition, we bought March D-marks and sold March Japanese yen, as a spread in equal dollar value at approximately .7722 cross.

On Friday Dec. 14, via flash update we sold long March D-mark positions at approximately .6177, cancelling the stop close only at .6110.

On Tuesday, Dec. 8, we lowered the stops on Canadian dollar to .7845 close only, basis March. Also, we recommended to sell French franc against the purchase of D-marks for three months' maturity.

On Wednesday, Dec. 9, we advised the purchase of March D-mark, then trading at .6279 and place stops at .6108, close only, basis March.

Friedberg's Commodity & Currency Comments (ISSN 0229-4559) is published by Friedberg Commodity Management Inc., 347 Bay Street, Toronto, Ontario, M5H 2R7.

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