FRIEDBERG'S

COMMODITY & CURRENCY COMMENTS

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It's inflation, alright

The US Consumer Price Index rose 0.3% in February. Excluding food and energy, the index rose 0.5%, that is, a 6% annual rate. In January, CRB inflation also rose at a 6% annual rate. While two months do not make a trend, they should raise our level of concern a notch or two. Especially when the Commodity Research Bureau Futures Price Index has risen more than 6% in little more than one month, not all attributable to the spectacular rise in lumber prices.

The non-worriers, i.e., bond bulls, make three arguments.

First, they say, the rise in various commodities is due to special factors: cold weather affected livestock movement, a storm aggravated Cuba's sugar woes, environmental regulation depleted timber stocks, and so on. This argument, of course, offers little or no consolation. Without monetary accommodation, these sporadic price rises should result in offsetting price declines in other sectors.

Simplistically, if consumers need to pay more for houses due to lumber price increases, they will have less money to buy computers or cars. Hence, the slumps in sales of the latter should affect negatively plastic and aluminium prices. When consumers, on the other hand, can "finance" these more expensive goods, either via credit or via a drawdown of liquid assets, without having to restrict other consumption, the *overall* price level is affected. The result is higher inflation.

The second argument ignores output prices: Unit labor cost, they say, dictate the pace of inflation. If they are well behaved, as they are now, there is little or no danger of accelerating inflation. This argument is based on the old cost-push theory that attributed inflation to labor's greed.

The fallacy is glaring: Wages, which are only one of the factors of production, albeit the most important one, *react* to inflation in the initial stages. As inflation accelerates, wage demand rises, not quite catching up to the loss of purchasing power until very late in the cycle.

The reason that wages lag inflation is simple: Employers, as well as employees, are always caught off guard by accelerating inflation. Employers benefit first, by a natural widening of their profit margin, but do not quite understand that this phenomenon is caused by inflation (we do not talk about specific sectors or industries, but the economy as a whole).

By the time industry realizes that inflation has accelerated and has benefitted by it, labor begins to bid for higher wages. Unit labor costs jump and give inflation an additional boost. As monetary policy becomes more restrictive, inflation subsides. Because of sheer inertia, labor costs continue to rise well past the peak of inflation, choking profit margins and helping to bring about the next recession. In short, unit labor costs are a good indicator of profitability (and a key component of our supply side spread) but a very poor predictor of inflation.

This "lagging" effect was well evident prior to the major inflation of the early '70s. To argue that there is no danger of accelerating inflation today because unit labor costs are barely rising is equivalent to driving while looking only at the rear-view mirror for signs of traffic.

The last argument is that the economy is far from being overheated, and in fact is still too weak to generate an acceleration of inflation. More specifically, the argument goes, the economy is operating below capacity and therefore price pressures are likely to be insignificant.

Even if we accept the argument that capacity constraints cause "price pressures," it is much too difficult to determine "capacity." On the labor front, increased medical costs along with new regulations surrounding family leaves, civil rights and disabilities may redefine the 6.5%-7% unemployment as full employment. Similarly, environmental and other regulations may re-draw our notion of full industrial capacity to where it is today (approximately 80%). In short, the incredible proliferation of new regulation may have brought us a great deal closer to full capacity than we suspect. If so, "price pressures" are a great deal closer than we suspect.

In this issue

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

The non-worriers should worry. Inflation is a monetary phenomenon. A look at recent money supply figures (see Chart 2) should convince us that the price behavior of the last two months is not a random event. There are those who argue that M2 rather than M1 is a more important predictor of inflation, among them Dr. Milton Friedman. We humbly disagree.

In the early '80s technological innovation distorted its close correlation to inflation. There is evidence that this "misbehaviour" was temporary and, once again, M1 is the aggregate that most faithfully tracks transaction balances. Of course, very low opportunity costs reflecting historic low interest rates may be partly responsible for the public's increased desire to hold currency and checkable deposits. That is, demand for, rather than supply of, money can be said to be growing rapidly, negating some of the inflationary implications.

A look, however, at the adjusted monetary base dispels this constructive interpretation. The base is controlled by the Federal Reserve and represents "pure supply." Chart 1 shows that the base, also, has been growing at too rapid a pace.

At the same time, the steepness of the yield curve and the fact that short-term rates (Fed funds, T-bill rates) are negative (a fact noted by a Governor of the Federal Reserve!) support the view that monetary policy has been too easy and that, in all likelihood, inflation is accelerating as the CPI and CRB numbers show. As we stated in our October 1992 issue, "...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."

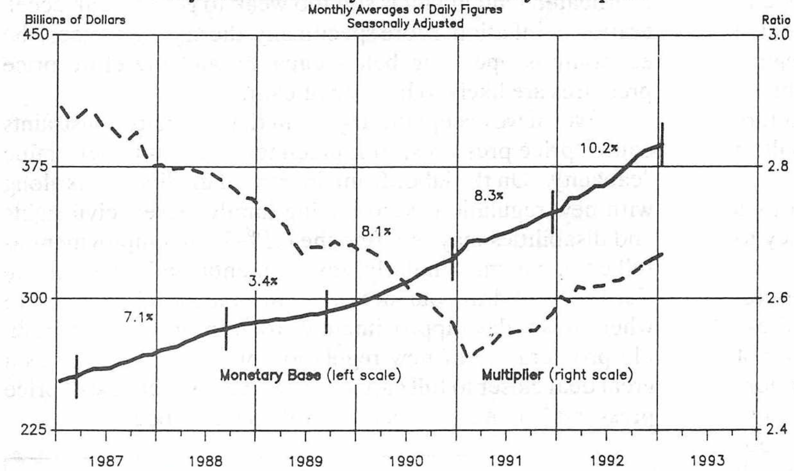
The implications are clear. Commodity prices, as we have been suggesting for months, are headed higher. Interest rates, too, are surely headed higher.

STRATEGY: *We purchased, once again, deferred T-bond puts (December 100s), adding to the existing long September 98 put positions.*

Look to establish "investment" positions in grains and precious metals.

Chart 1

Adjusted Monetary Base and Money Multiplier



The adjusted monetary base is the sum of reserve accounts of financial institutions at Federal Reserve banks, currency in circulation (currency held by the public and in the vaults of all depository institutions) and an adjustment for reserve requirement ratio changes. The major source of the adjusted monetary base is Federal Reserve credit. Data are computed by this bank.

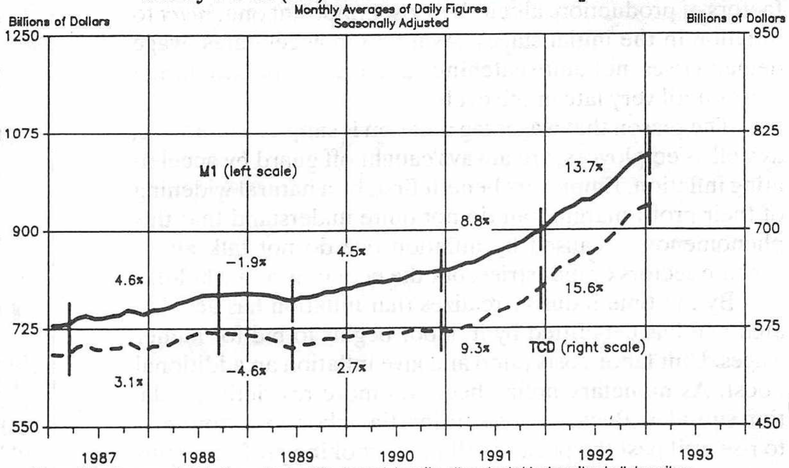
Money multiplier is the ratio of M1 to adjusted monetary base.

Percentages are annual rates of change for periods indicated.

Prepared by Federal Reserve Bank of St. Louis

Chart 2

Money Stock (M1) and Total Checkable Deposits



M1 consists of currency held by the nonbank public, demand deposits, other checkable deposits at all depository institutions and travelers checks.

Total checkable deposits is the sum of demand deposits and other checkable deposits at depository institutions.

Percentages are annual rates of change for periods indicated.

Prepared by Federal Reserve Bank of St. Louis

JAPAN

Outright contraction?

Having spent most of its ammunition supporting stock prices above the magical Nikkei 17,300 area (the approximate close last Sept. 30, a day of reckoning for the banking system and every subsequent six-month period), and looking increasingly desperate, the Japanese government pulled a new trick out of the hat: Talk up favorable rate changes for the 65%-owned telecommunication giant Nippon Telephone & Telegraph, and let the market do the climbing.

The partially privatized NTT reached a peak of ¥3.2 million in April 1987, having sold three tranches to the public at an average of ¥1.9 million. Subsequently, prices fell steadily to reach a low of ¥453,000 last August. Since the profitability of the company is almost entirely in government's hands, it was not too difficult to change its prospects. In so doing, the government would accomplish two objectives: force the shorts to cover, pushing up the Nikkei above the danger zone before March 31; and appease the thousands of little investors who were sucked into the most deplorable privatization in history.

The *discussion* of rate changes convinced analysts that the company's operating earnings could double in the year to March 31, 1995, which would put NTT on a prospective price-earnings ratio of 35.

The stock climbed to ¥845,000 from ¥616,000 Feb. 26, a dramatic rise of 37% which helped the Nikkei climb to 18,900 from approximately 16,800. The manipulation had been a smashing success.

At this time, however, it is not at all clear that the Ministry of Ports and Telecommunications will go along with the ploy. It appears that, sensibly, the ministry wants NTT to shape up and face the competition in its long distance operations without resorting to cross-subsidies from its rent as a monopolist in the domestic call business. It is also not clear that, despite NTT's better prospects, the rest of the list can support these rarefied levels.

Monetary policy still remains too tight (with M2 and CD barely eking out a gain on a year-to-year basis) in view of the ongoing deflation in property prices (it is being said that the BOJ wants to keep the pressure until condominium prices in Tokyo fall to the equivalent of five years of an average worker's wage — and they are getting close).

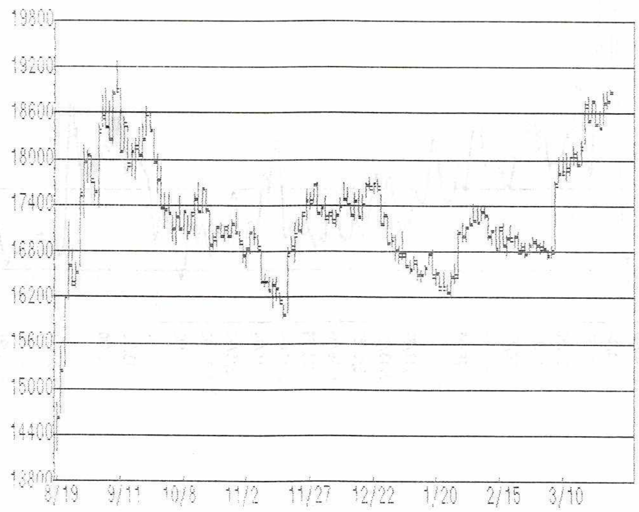
Fiscal policy is likely to shift towards expansion, although most of the talk has centered around reallocating funds and accelerating (front-loading) public spending programs. In essence, the LDP has as yet not decided to use deficit bonds. Without an aggressive program of deficit financing, the private sector will continue to contract.

Short of massive deficit spending, Japan is likely to head into outright contraction (as opposed to a mere growth recession), with rapidly rising unemployment, negative (recurring) profit margins and some bank failures. Interest rates will have to be lowered to help banks fund their enormous portfolios of non-performing loans, the stock market will fall under its own weight, and the trade surplus will continue to grow.

The big "if" remains the fiscal package....

STRATEGY: *Remain short the Japanese short market via American Stock Exchange-traded puts. Remain long Simex June and September '93 Euroyen futures and calls. Place stops at 96.50, basis June '93, close only. We liquidated long Yen positions in view of the extremely high consensus of bullishness, and the uncertainty regarding the new budget proposals.*

Chart 4
NIKKEI 225 INDEX SPOT



STOCK INDEXES

S&P 500: reckless buying a sign of the top?

On Feb. 12, after liquidating profitably our long S&P 500 futures and calls, we put out a new short position via puts, with stops above 444.00, basis the cash index. While we were stopped out, the action has not been all that convincing, and once again, via the Hotline of March 19, we recommended going short outright June S&P 500 futures, with new stops at 455.00, good anytime.

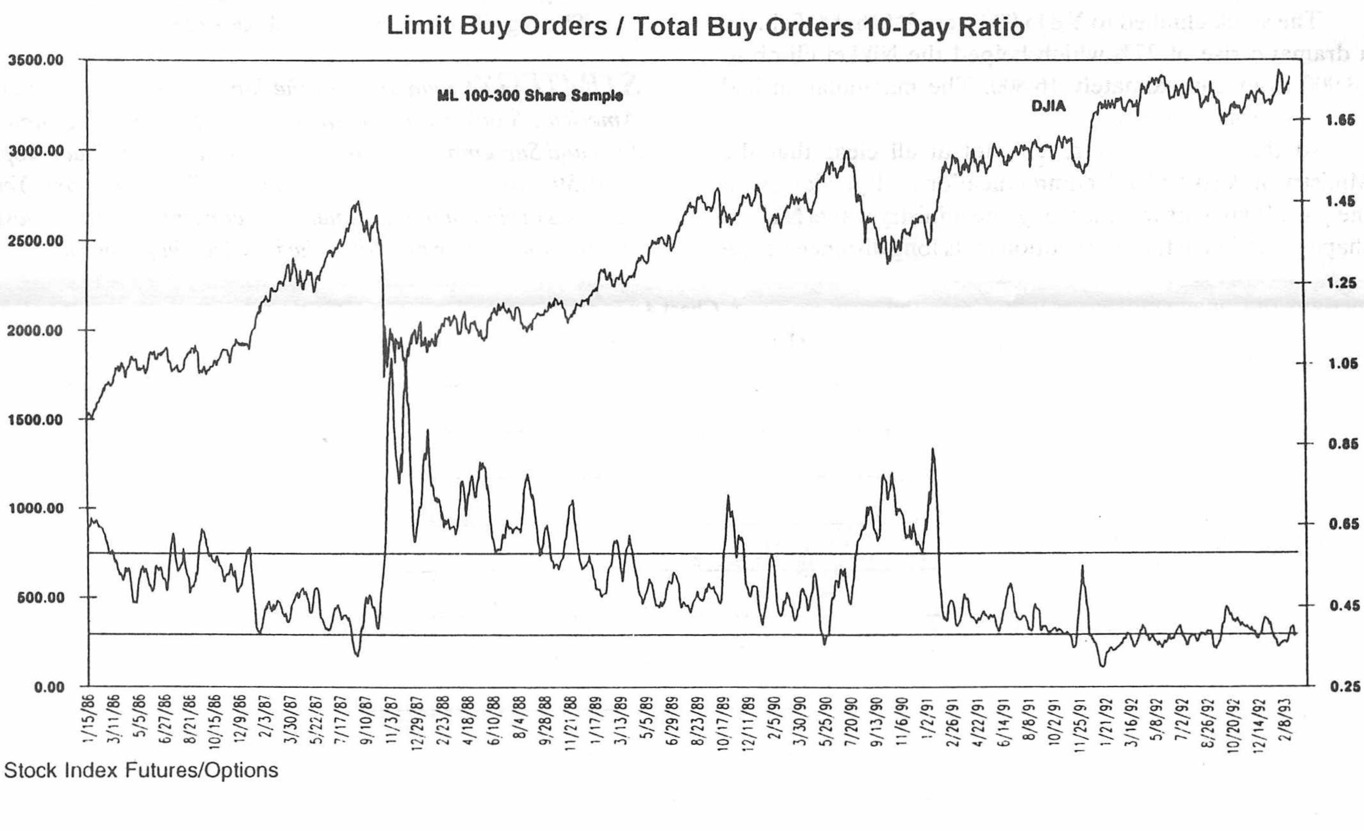
Aside from obvious valuation problems and the increasing probability that yields have bottomed, our main concern lies with the recklessness and total abandon with which the public has been buying stock.

Merrill Lynch has devised a useful indicator: the limit buy/market buy ratio placed by its own customers. To arrive at this ratio, which reflects public sentiment, they divide limit-buy orders by market-buy orders. When the ratio is rising, investors are being more cautious. A rising trend in the ratio when the Dow Jones Industrial Average (DJIA) is falling has bullish short-term implications. A declining trend in the indicator, accompanied by a rising trend in the DJIA indicates that investors are more aggressive, or at least complacent about possible weakness. That has often occurred near trading peaks and intermediate-term or market tops.

At the present time (see Chart 5) the indicator is declining, and the DJIA has been rising. More interestingly, the period of "low readings" is the longest since the mid-'80s, surpassing even the "lack of caution" that preceded the '87 crash. It is also important to note when gauging public sentiment that in addition to outright market purchases, the public has been engaged in an orgy of indirect purchases, via mutual funds. The combination of direct and indirect "market" purchases describes an unsustainable blow-off, but one that can last longer than we think. Therefore, tight stops and/or the use of options are highly recommended.

STRATEGY: *You are short June '93 at around 449. Maintain stops at 455, good anytime.*

Chart 5



Stock Index Futures/Options

CANADA

Mr. Chretien and his inflation machine

"I used to think of government — meaning good government — as the major force at work in the civilizing process," Toronto author Jane Jacobs writes in *Systems of Survival,* a masterpiece of socratic analysis and libertarian economics. "Now I'm inclined to think of government as essentially barbaric — barbaric in its origins and forever susceptible to barbaric actions and aims."

Some other agent must therefore act upon government, she writes, to civilize it, to make it respect "private plans, private property, and personal rights." As *Systems of Survival* persuasively holds, this civilizing agent must be the free market.

In this perspective, money-market investors act as a civilizing agent by punishing governments for accumulating excessive public debt and by rewarding them for fiscal restraint; they measure barbarism in basis points. Governments acknowledge this taming influence, as they must — they cannot escape it. Yet they resist it. By instinct and inclination, they indulge in precisely as much barbaric behavior as they think compatible with survival.

Canada's autumn federal election will be fought, almost exclusively, as a referendum on fiscal and monetary barbarism. Do Canadians want more inflation or do they want less inflation? In Jane Jacobs' analogy, do Canadians want more barbaric government or do they want more civilized government?

With Conservative Prime Minister Brian Mulroney's decision to step down in June, Canadians now await the selection of their next national leader; they assume it will be Defence Minister Kim Campbell, who is generally regarded (mostly on faith) as a fiscal and monetary civilizer. In a market sense, however, the decision will have limited short-term relevance. For the duration of the election campaign, the Conservatives will be led — figuratively but effectively — by Bank of Canada Governor John Crow, the resolute champion of a sound, civilized currency.

Wiggle as he or she may want to wiggle, Canada's next prime minister *must* defend Mr. Crow's sound-money strategy. The markets are an informed electorate unto themselves; they, too, will vote. And they will vote *before* the nation itself votes. They won't embrace Kim Campbell (or anyone else) on faith alone. They *will* vote for Mr. Crow. They will do so because Mr. Crow is Canada's only credible evidence of governmental commitment to *long-term* monetary good behavior.

Mr. Crow's seven-year mandate as governor of the Bank of Canada expires 10 months from now. Will he be given another term? Canada's next prime minister must signal the market electorate that he will. This signal will, in itself, define the national election: for the Opposition parties have already signalled that Mr. Crow must go.

The electoral dynamic in this analysis simplifies things remarkably. It makes the emergent regional political parties (the Reform Party, the Bloc Quebecois) mere distractions; it heralds a direct confrontation between the Progressive Conservative Party (the "civilizers") and the Liberal Party (the "barbarians"). With Kim Campbell as prime minister, and with economic responsibility as her platform, the Conservatives should be expected to win in a landslide, and the socialist New Democrat Party should be expected to disintegrate in the high-impact collision of the Conservative and Liberal parties.

The Liberal Party has already articulated its more-inflation policy in a way that makes retreat from it difficult, and perhaps impossible. In a series of "major speeches," Liberal leader Jean Chretien has castigated the Bank of Canada for its "zero-inflation obsession." He has denounced the bank's mid-term and long-term inflation targets. He has proposed that Canada pursue an inflation rate "competitive with our major trading partners." He has asserted that Canada's inflation rate should be permitted to drop below the US rate "only in very unusual circumstances." He has declared that the Bank of Canada must be compelled to adopt a more "flexible" monetary policy that will "support (the government's) worthwhile domestic objectives."

These positions put Mr. Chretien and the Liberal Party in irreconcilable conflict with the government, certainly; and with the central bank, decisively. They define inflation as a public good. They say that Canada has a right to as much of it as the next country. ("We are entitled to be as barbaric as they.") They establish higher inflation as a policy prerequisite for a Liberal government.

In intellectual terms, this policy rests upon the statist doctrine that market economies require some unknown degree of chronic inflation as a mechanism of social reconciliation. (Governments can more frequently say "yes" to more people.) A corollary stipulates that governments must (when "necessary") print enough money to keep interest rates down.

Mr. Chretien, though, is a thorough pragmatist. He advocates higher inflation only to gain the political advantages that it bestows. Canadians are tired of recession and tired of restraint. Many Canadians remember the inflationary '70s (and a Liberal government) as the good old days. Nostalgia, though, isn't what it used to be. This particular memory is a nostrum, nothing more.

Yet by expressing economic choices in terms that people understand, it is definitive. It is also risky. *Mr. Chretien can win the electorate only by losing the market.*

Even as Mr. Chretien introduced his inflation platform to Canadians, Mr. Crow made his own sound-money position abundantly clear to the international investment community. What would be his own response to a government directive for higher inflation? In a February speech in South Africa, he explained:

The Bank of Canada Act provides an explicit directive power through which the Minister of Finance can override the bank's monetary policy decisions. The directive must be in writing, in specific terms, and applicable for a specific period. Furthermore, it must be made public as soon as it is issued.

No [such] directive has ever been issued, but it has been recognised from the time the mechanism was put in place that, if one were issued, a likely outcome would naturally be the resignation of the Governor. I say "naturally" because, if the Governor in good conscience agrees to the course of action advocated by the Minister, no directive would be necessary.

Although expressed with the restraint appropriate to a central banker, Mr. Crow's message is simple. Mr. Chretien (or anyone else) will kindle inflation only over Mr. Crow's dead body. Confrontation of this kind would obviously produce a cataclysmic market event; any reasonably sane government, in Canada's precarious financial environment, would defer to the central banker. Yet even the *potential risk* of such a confrontation could produce an equivalent market reaction. Investors, after all, won't suspend their judgment of risk until they find Mr. Crow's body, prostrate and cold, on the floor.

Mr. Crow believes that the single responsibility of a central bank in a market economy is "a money that people trust." He has given Canadians a money that is within two percentage points of trustworthiness, a significant achievement in four years and in a country where fiscal practice has produced gargantuan public debt. He knows, however, that the achievement will be wasted unless investors are persuaded that it will be protected; and protected for *many, many* years.

As noted earlier, Campbell & Crow should be expected to triumph over Chretien in next autumn's decisive encounter. Put this way, though, the equation isn't complete. Mr. Chretien has allies in provinces. Most of the provinces are essentially insolvent; and sound-money principles will not help them escape the consequences of their debt. In a February report on federal and provincial debt, the C.D. Howe Institute shocked Canadians will its warning that a catastrophic debt crisis could hit the country at any time. In a March report, the institute bluntly discussed the federal government's options in bailing out the provinces.

The fundamental question in all of this is inescapable, and the answer imminent. Will Canada monetize its public debt? Will the federal government direct the Bank of Canada to buy provincial debt, and print the money to pay for it? Only days ago, in a rare public comment on current public-policy controversy, Mr. Crow said simply: "We (the bank) do not make such loans." Yet *any* unilateral action by the federal government to rescue a province from its debt will perversely strengthen Mr. Chretien's inflationary message — that the only way out of governmental bankruptcy is the easy way out.

We must regard the next few months, therefore, as the equivalent of a drug addict's first few months in withdrawal. Ontario's provincial budget in May will determine the debt-dependency of Canada's largest province. The Conservative leadership race that follows will test the party's "just say no" principles. The campaign that follows will find permissive politicians offering free samples of an alternative economic reality from coast to coast.

As the C.D. Howe Institute observed, the root cause of Canada's problems is government deficits and "the only remedy is to stop." The choice, as always, is between barbarism and civilization. The markets will have several golden opportunities this year to express their civility.

In the meantime, buy Jane Jacobs' *Systems of Survival* (Random House, $27.50). It's an excellent investment.

– Neil Reynolds

STRATEGY: *Heavy provincial borrowing coupled with a better sentiment regarding the political outlook are providing good support around the 1.25 area. Tighten stops to 80.10, basis June, good anytime. If stopped, there will be a better selling opportunity in the next few months.*

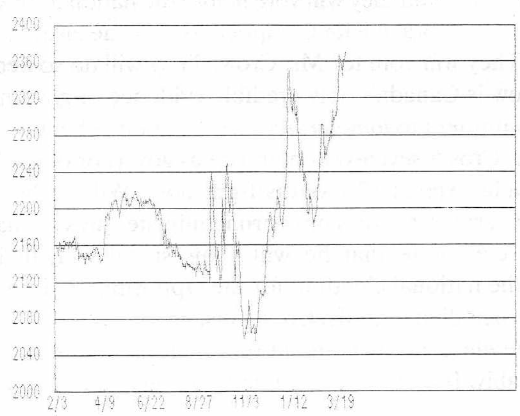
LIRA/STERLING

Bullish . . . long term

We have not forgotten our long Italian lira/short Sterling position (as much as we would like to forget it). The political disintegration of the Italian republic is bearish in the near term but extremely bullish long term.

If you can afford to maintain this position, do so. You should pick up points in the rollover.

Chart 7 – LIRA PER B.P.



NEW ZEALAND

The kiwi revisited

Last month, we gave three cheers for New Zealand's economic performance and prospects. Specifically, we concluded that long-term nominal interest rates would fall and that the export-led recovery would be sustained. Consequently, we recommended that long dated bonds should be held outright and that long speculative positions should be established in the bond futures market. Moreover, we mentioned in passing that the equity and real estate markets offered long-time investors attractive opportunities. (We offer specific products to take advantage of those opportunities.) In this essay, we continue our analysis of New Zealand and use as our point of departure the recently released OECD *Economic Surveys: New Zealand.*

New Zealand registered very weak growth in the 1950-85 period, with per capita income growing at just 1.4% per annum compared with 2.9% for the OECD as a whole. That slow growth was accounted for mainly because of persistent slow growth in productivity. For example, inputs (labor and capital) contributed over two thirds to New Zealand's economic expansion between 1950 and 1985, while the addition of those inputs accounted for less than one half of the expansion of the leading OECD economies (the United Kingdom, United States, Germany, France, and Japan). In those countries, the efficiency with which labor and capital were used (that is, total factor productivity) contributed most to economic growth. That was not the case in New Zealand.

In the 1950-85 period, New Zealand's economy was not conducive to economic efficiency. It was one of the most protected in the OECD, suffered from input and output market rigidities, and supported very high effective tax rates. In short, the micro, or structural, side of the economy was blocking the efficient allocation of resources. In addition, macroeconomic policies accommodated external shocks. Hence, New Zealand had high and variable rates of inflation. Not surprisingly, investment was misdirected, and there was little competitive pressure to control costs in what has been described as a "cost-plus economy."

In 1984, a program of microeconomic, or structural, reforms was launched. Those supply-side reforms included the deregulation of key sectors of the economy, cuts in agricultural subsidies and export assistance, and reductions in tariffs and quotas. The tax system was reformed, privatization launched, and government accountability programs instituted. Consequently, New Zealand has one of the least distorted tax systems in the OECD, the lowest OECD producers' subsidy levels, a liberated trading system and a relatively efficient public sector. In addition, the Reserve Bank Act of 1989 gave the central bank independence and allowed it to pursue a single goal: price stability.

Even with these supply-side reforms and a new focus on price stability, New Zealand's economic performance continued to decline during the 1985-90 period. The reasons for that subdued response were both endogenous and exogenous.

First, considerable pressure was placed on the tradeable goods sector. Financial liberalization and restrictive macroeconomic policies resulted in high real interest rates and a high exchange rate. That squeezed exporters' profits and increased pressures on those who faced increased competitive pressures following trade liberalization.

Second, economic policy credibility was slow to be established. Hence, wage growth continued to be strong as inflation expectations remained high, even though inflation continued to decline.

Third, an adjustment in asset prices across sectors of the economy was slow to develop.

Fourth, the stock market crash of 1987 exposed weak corporate balance sheets and led to a contraction in the demand for financial services.

Finally, the pace of economic reform slowed after the initial burst between 1985 and 1988.

By the time the general elections of October 1990 rolled around, macroeconomic imbalances, high debt levels, inflexible labor markets, pressures on tradeables, and welfare state features remained in varying degrees.

The new government came in with another burst of supply-side reforms. Reforms designed to liberalize the labor market and eliminate rigidities were pursued with the Employment Contracts Act of 1991.

The Act has six principle components covering issues with regard to membership, bargaining, enforcement, strikes and lockouts, dispute settlement, and minimum wages. The transition to the new Act, which fosters competitive labor markets, has been smooth, and the Act has received widespread support. The most significant feature of new outcomes that are emerging is a switch towards enterprise-based bargaining.

Consequently, communications have been improved, flexible working hours introduced, and performance-based pay systems adopted. Wage demand have been modest (realistic) under the new, deregulated bargaining system.

New Zealand's welfare system has also undergone major changes since 1990. Those changes relate to both funding levels and the situation of the system. Welfare reforms have been aimed at increasing self-reliance by promoting participation in the labor force and increasing charges for the provision of retirement income, health services, housing and accident insurance.

On the monetary front, the 1989 Reserve Bank Act has become the cornerstone of macroeconomic policy. It has made the central bank the most independent in the world, with a single objective: to hit the Policy Target Agreement of 0% to 2% year-over-year consumer price inflation. To hit that target, the Bank has adopted a sound Wicksellian framework in which it targets the exchange rate, the level and structure of interest rates, the output gap, and to a lesser extent monetary aggregates. The September 1991 easing of monetary policy and consequent decline in the effective exchange rate has been the clearest example of an explicit policy response to the improved inflation outlook. Policy credibility has been improving dramatically. Consequently, inflation expectations have been falling rapidly and, as we concluded last month, will continue to do so.

As a result of the new government's policy thrust, the economy turned around in the third quarter of 1991, as domestic demand bottomed out and strong export growth continued. That recovery is atypical for New Zealand. It has been export-led rather than domestic, and it occurred when world growth and commodity prices were weak.

The OECD projects that the recovery will continue at a pace of 2.5%-3.0% to 1994. We agree. That said, we must mention that there is only one risk in that forecast: fiscal policy. A fiscal deficit of 3.4% of GDP was registered for the fiscal year 1991-92 (ending in June), and it appears that there will be some increase in the deficit this fiscal year. Then the deficit is scheduled to decline to 2.7% of GDP in 1994-95. With a relatively high level of external debt, it is important that those targets are realized as there is little room for a weakening of resolve. We are confident, however, that resolve will hold and that the risk will not materialize.

IMPLICATIONS: A careful reading of the OECD's extensive report on New Zealand leaves us even more confident than we were last month. The new government's supply-side reforms and sound money policies will finally slay the welfare state dragon. We again must give New Zealand three cheers.

– Dr. Steve H. Hanke

COMMODITIES

Commodities climbing

During the past month, we have witnessed what would appear to be the long-awaited debut to the bull market in commodity prices, which we have been predicting for months, since our October 1992 issue ("The Moneary Time Bomb" and "Assets Again?").

During the month, the CRB (Commodity Research Bureau) Index advanced from under 203 to 211.50 (as of Friday, March 27), a gain of 4%.

Over the same period, the four commodities we held in our portfolio performed as follows: corn 5%; cocoa -2.3%; silver 4%; sugar 19%. In aggregate they increased by 6.4%

(New readers will want to understand that in October 1992 we adopted the strategy of regarding commodities markets as an asset class — as opposed to trading vehicles — and began accumulating outright long positions on a long-term buy-and-hold basis.)

Where are commodities most likely to go from here? When the economy emerged out of the 1980/81/82 recession the CRB advanced for two years and by 25% from the lows recorded at the recession's trough. Some of this rise is certainly attributable to the different mindset of the market at the time.

Unlike now, traders were acclimatized to inflation, and the notion of falling prices was regarded with the same kind of scepticism as is the notion of rising commodity prices today. However, the surprise elements are the fact that the new cycle is beginning in an environment defined by borrowing costs that are at 30-year lows; the fact that many important commodities (silver, gold, corn, cocoa, gold, and soybeans) are offered in real-terms at near post-World War II lows; and the fact that emerging economies in Asia (and to a lesser, but expanding, extent in Eastern Europe and South America) now constitute so large a proportion of exploding world trade.

All these factors lead me to conclude that in this new cycle the CRB will climb by *at least* 25%, or to 245, before the overall trend is seriously threatened.

Remarks regarding the individual commodities in our portfolio follow.

Corn

The market has erupted out of a long, long base. In addition to its cheapness, it has fine fundamentals. The USDA (US Department of Agriculture) had halted shipments to Russia for nonpayment. Last Monday, immediately on the heels of the outbreak of the Yeltsin crisis, the department announced a 210,000 ton corn donation to Russia.

With anarchy once again threatening The New World Order (for lack of a better phrase), we might presume the US will resume feed (and perhaps other) grain shipments. One million tons of corn have been sold to Russia but not shipped. Also, early surveys have indicated farmers expect to plant fewer acres of corn this spring. Finally, free stocks of corn will be reduced this spring in response to the USDA's allowing an additional 300 mln tons (to 900 mln tonnes) into the farmer-owed reserve program.

STRATEGY: *Remain long futures with stops at 217, basis May.*

Cocoa

For the second month in a row, the market responded to a bullish article by this author by immediately — i.e., *the very next day* — tumbling $50 per tonne. Last month's collapse came about in response to reports that rain had fallen in key West African regions, which have been plagued by drought. The reports proved false; the rain was concentrated in grain producing areas in more southerly parts of Africa. Prices recovered, but not to the extent one might have expected given the fundamentals (which we described at some length last month) and the rise in the CRB.

Cocoa seems a market that has been trapped by its own poor technical picture; skeptics can reasonably point out the market has been in a downtrend for a decade and a half. Given the fundamentals, this view rings of complacency. As an asset, cocoa is undervalued.

STRATEGY: *Remain outright long futures.*

Precious metals

We are pleased being long silver, and to it now advise adding gold. The yellow metal is extremely sensitive to inflation. In 1992 global demand increased by a whopping 9% with the majority of it coming, commercially, from the jewellery sector (+14%) and geographically from Asia (+23%), neither of which show any indication of abated demand. The market has withstood an onslaught of producer selling in the recent mini-runup. And the open interest has taken on a decidedly bullish aspect.

Open interest refers to outstanding or unliquidated positions comprising a commodities market. The CFTC (Commodity Futures Trading Commission) publishes Open Interest data divided into three categories: commercial hedgers, large speculators, and small speculators. The long and short position of each category is indicated in bi-monthly reports, as are the changes in the long and short position since the previous report was published.

It is generally conceded that of the three categories making up open interest, commercial hedgers are the most sensitive to market fundamentals. This is not only because of working in the industry, they are privy to information only the most dedicated speculator could obtain, but also because commercial hedgers are assuming futures positions against physicals. They are "trading the basis," the different between cash and futures, which is considerably less volatile than just an outright position, and therefore less likely to induce emotionally-based buy or sell decisions.

Large speculators are largely technicians using systems to identify trends. Small speculators tend to be losers more than 80% of the time.

Knowing all this we should be able — after taking into account seasonal factors that influence behavior of commercial users — to use the relative positions of the various open interest categories to predict prices to some extent. Indeed as Chart 8 shows, net changes in the position of commercial hedgers has been a fairly reliable indicator of changes in the CRB going back to the beginning of 1986.

(It is noteworthy that the present picture of the CRB is an extremely bullish one.)

The week of March 7, when gold made the bottom from which it began its current advance, a significant shift occurred in the market's composition. Commercial hedgers increased their long position by 9% — a huge amount — and decreased their short position by 17%!!! At the same time, both large and small speculators increased both their long and their short positions, but small speculators increased their short position by 21%!!!

It would seem a shift in the open interest of this magnitude would indicate a positive bias in prices.

***STRATEGY:** Buy deferred futures positions to take advantage of any rise in short-term rates. Place stops at 325, basis cash.*

Sugar

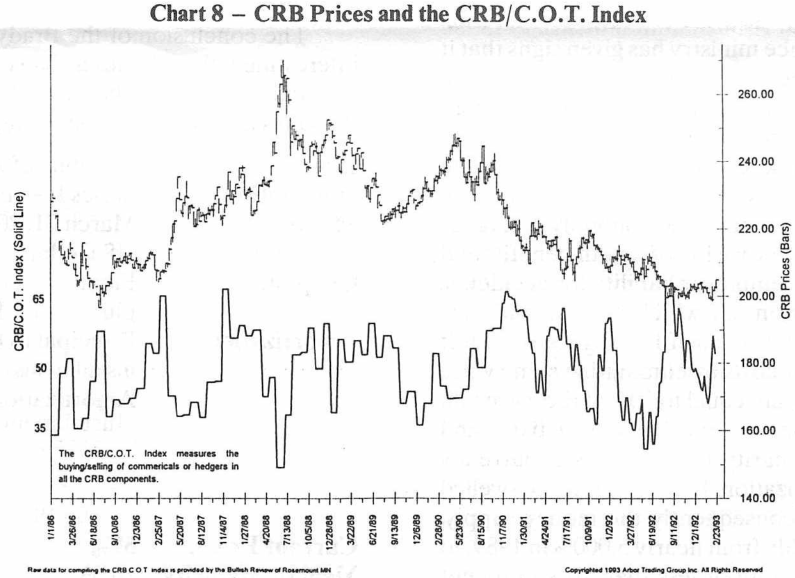
As I wrote last month, a sharp run-up to above 11.5¢ should be used as an opportunity to take profits on sugar futures. We did so (Hotline Update for March 16). Sugar is not nearly as cheap in either historical terms or relative to the CRB as the other commodities in our portfolio. Also, as I wrote last month, sugar does not enjoy the trend of consistently increasing demand, the type of demand that is unlikely to be quickly braked by a bull market of substance. On the contrary, sugar has become quite price elastic since the industry began expanding sales into the third world in the early 1980s. Also the open interest analysis we have applied above is not at all bullish regarding sugar.

Any bull move must come from the supply side where information is never as forthcoming as we, as speculators, would like it to be. The storm that devastated the North American southeast visited poor Cuba, the world's largest exporter, with hardship it can ill afford. The already beleaguered crop is now estimated *at least* 23% less than last year. China is expecting a crop 2% less than last year; India, the world's largest producer, is expecting 14% less; and Thailand's crop is expected to fall by a near-incredible 31%. Of the top five producing nations, only Brazil is expecting a larger crop than in 1992 — +5%.

***STRATEGY:** Given the shrinking supply (to what now appears the first deficit year since 1988/89) and taking into account the traditional volatility of the sweetener — there is no other commodity like it! — we would advise purchase of calls on the October contract at below ??¢. At this point we would advise risking the entire premium if filled.*

– David B. Rothberg

Chart 8 – CRB Prices and the CRB/C.O.T. Index



Courtesy *The Bullish Review*, 1460 Blaine Avenue East, Resummoned M 55068 (612) 423-4949

FRIEDBERG CAPITAL MARKETS

Argentina: Still in Act II

Last July we ran a brief article on Argentina that we titled "Act II." We wholeheartedly recommended the purchase of domestic peso-denominated government debt. While debt prospects remain excellent, we still believe that Argentina is in the middle of a process that will require a great deal of fortitude and conviction.

The problems continue to manifest themselves in the public sector and in the labor market. While the public sector fiscal balance moved from a deficit equal to 16% of GDP in 1989 to a small surplus of 0.2% in 1992, much of the improvement is credited to a rapid increase in taxes, with tax revenues rising from 15% of GDP in 1989 to 24% of GDP in 1992.

The increase of the burden of taxation has had a contractionary effect on the private sector as well as a inflationary one (particularly the VAT). Nonetheless, the impressive stabilization program put into effect in March 1991 through the Convertibility Law helped achieve substantial gains in industrial production at least until mid-1992. It was this steady suffocation of the private sector that worried us last July; the events proved us correct. Industrial activity has since then slowed down considerably.

For the coming 1993 year, the public sector's primary balance (fiscal balance less debt service payments and excluding revenues from asset sales) must increase from a $3 billion surplus to a $4.4 billion surplus in order to meet the fiscal targets of its extended fund facility renegotiated with the IMF in December. Given that fiscal spending is forecast to increase $6.2 billion, public sector revenues must increase $7.3 billion (the proceeds of privatization of up to $350 million will also be counted as part of the projected surplus).

Will the government raise taxes once again and threaten to create a recession or will it bite the bullet and reduce public sector spending?

While from a Keynesian point of view both choices are similar in their impact on the economy, from a supply side point of view the latter is by far the more favorable alternative. In recent days the finance ministry has given signs that it will follow this second, more favorable, course of action. In effect, it has requested 10% cutbacks in every department except social security and debt service.

The second problem relates to the cost of labor. The government has tried, unsuccessfully thus far, to modify the rules for wage-bargaining, eliminate the monopoly that labor unions currently enjoy in the provision of health benefits and make substantial changes to employer liability for accidents, sick-leave and job-termination, all which are currently extremely high. The administration itself has suggested that it may attempt to reduce labor costs by eliminating some wage taxes, which in the aggregate are equal to 50% of the wage bill.

The 1991-92 boom rode on the back of a fixed and credibly fixed peso/dollar parity (designed as a currency board) and large scale privatization. Foreign influence swelled international reserves and consequently the money supply. Domestic inflation fell steadily from nearly 5,000% in 1989, to 17.5% in 1992, to an annual rate of less than 10% in recent months. On the path to convergence with international rates of inflation, the peso has appreciated substantially in real terms, primarily via the rise in prices in the non-tradeable sector. (Wholesale prices, which more closely reflect tradeable goods, barely rose 3.3% in the year to January.)

This peso appreciation has had a profound impact on the trade balance: Argentina's trade balance fell from a surplus $4 billion in 1991 to a deficit of more than $3 billion in 1992. While the trade deficit in 1992 was easily financed through capital inflows, the rapid deterioration in trade balance may raise questions about Argentina's commitment to a fixed peso parity. Just a few months ago a run on the nearly impregnable reserve position of the central bank (under the current regime, there is one dollar backing for every peso in circulation) was stilled only after interest rates skyrocketed above 50% per annum.

In sum, Argentina's economic transformation has been rather dramatic. Once again financial deregulation and liberalization preceded deregulation and liberalization of the real sector of the economy, creating a number of problems that as yet have to be resolved. The government has shown unusual firmness and determination to resolve these issues, finding opposition even in the ranks of its own constituency. Interestingly, the government has discovered that austerity policies are more popular in a parliamentary election year than the old style populist measures.

The severity of the ongoing recession will test President Menem's resolve, but we believe that he has no choice but to continue on course.

Investment opportunity

Our purchases of the BIC V for the past 18 months have proven enormously rewarding, with returns exceeding 20% to 23% per annum. For details of this issue, please refer to our comments of Jan. 26, 1992.

Unfortunately the bond is now trading at a 9% premium over par, lowering the return to new buyers and exposing them to the (small) risk of redemption at par.

The conclusion of the Brady Plan has created new and interesting debt vehicles as bank debt has been transformed into tradeable bonds. The most interesting issue in our opinion is the series L floating rate bonds. Here are the terms of this bond:

Issuer:	Republic of Argentina
Description:	Series L — Floating rate bonds
Maturity:	March 31, 2005
Currency:	US Dollars
Coupon:	Floating Rate of 13/16% plus 6 mo. LIBOR semi-annually
Amortization:	Principal to be repaid in 19 semi-annual installments commencing on March 31/95

Amortization Installment	Principal Repaid
1 - 7	1.0%
8	5.0%
9 - 19	8.0%

Current Price:	57⅞
Yield to Maturity:	16.38%

Dealers calculate the yield to maturity by adding the spread (13/16%) to the equivalent fixed rate bond (on a swap basis) plus amortization. This will yield a stream of coupons that can then be put into the following formula.

Current Price =

$$\frac{\frac{\text{COUPON}_2}{2}}{\left(1+\frac{\text{YTM}}{2}\right)^1} + \frac{\frac{\text{COUPON}_2}{2}}{\left(1+\frac{\text{YTM}}{2}\right)^2} + \cdots\cdots\cdots\cdots \frac{\frac{\text{COUPON}_{24}}{2}}{\left(1+\frac{\text{YTM}}{2}\right)^{24}}$$

Where coupon_1 is the first coupon, coupon_2 is the second coupon etc. and YTM is the yield to maturity.

The difficulty in calculating the yield to maturity resides in the fact that we do not know what the six-month LIBOR rate will be over the next 12 years. That is why dealers will take the equivalent fixed rate bond on a swap basis. In effect, the steeply positive yield curve "forecasts" a rising six-month LIBOR rate. The effect of this calculation produces a prospective 16⅜% yield to maturity at a price of 57⅞.

We prefer a more simplistic approach. We assume that today's six-month LIBOR rate of 3⅜% is the *minimum* rate that will prevail over the next 12 years (given our outlook on inflation and interest rates). If that is so, the *minimum* internal rate of return to be earned by this bond if purchased at 57⅞ is 14.99% (see Chart 11).

We believe these bonds represent an unusual opportunity for capital gain and high yield for risk-conscious investors. The bonds are trading when and as issued; they are expected to be settled before the end of April.

Chart 11

	ARGENTINA				
	Floating Rate Bond				
Cash Flow Analysis and Internal Rate of Return					
dates	invst	interest	amortization	reinvstment	total cash flow
31-Mar-93	-57.8750	0.0000	0.00		-57.8750
30-Sep-93		2.0938	0.00		2.0938
31-Mar-94		2.0938	0.00	0.0438	2.1376
30-Sep-94		2.0938	0.00	0.0886	2.1823
31-Mar-95		2.0938	0.00	0.1343	2.2280
30-Sep-95		2.0938	0.00	0.1809	2.2747
31-Mar-96		2.0938	1.00	0.2286	3.3223
30-Sep-96		2.0728	1.00	0.2981	3.3709
31-Mar-97		2.0519	1.00	0.3687	3.4206
30-Sep-97		2.0309	1.00	0.4403	3.4713
31-Mar-98		2.0100	1.00	0.5130	3.5230
30-Sep-98		1.9891	1.00	0.5868	3.5758
31-Mar-99		1.9681	1.00	0.6616	3.6298
30-Sep-99		1.9472	5.00	0.7376	7.6848
31-Mar-00		1.8425	8.00	0.8985	10.7410
30-Sep-00		1.6750	8.00	1.1234	10.7984
31-Mar-01		1.5075	8.00	1.3495	10.8570
30-Sep-01		1.3400	8.00	1.5768	10.9168
31-Mar-02		1.1725	8.00	1.8054	10.9779
30-Sep-02		1.0050	8.00	2.0353	11.0403
31-Mar-03		0.8375	8.00	2.2664	11.1039
30-Sep-03		0.6700	8.00	2.4989	11.1689
31-Mar-04		0.5025	8.00	2.7327	11.2352
30-Sep-04		0.3350	8.00	2.9680	11.3030
31-Mar-05		0.1675	8.00	3.2046	11.3721
Internal Rate of Return:			14.99%		
Assumptions					
LIBOR:	3.3750%	For the life of the bond			
SPREAD:	0.8125%				
Reinvestment of all the cash flows at current LIBOR rates					

Chart 12
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**

	U.S. $	NEW ZEALAND	AUSTRALIAN $	SWISS DEUTSCHEMARK	JAPANESE FRANC	DANISH YEN	BRITISH KRONE	FRENCH POUND	EUROPEAN FRANC	CANADIAN CURRENCY UNIT	SOUTH AFRICAN DOLLAR	ITALIAN RAND**	ARGENTINEAN LIRA	FINNISH PESO	MARKKA
1 year	2.96%		C.B.A. '94 yields 6.13% (.6880 A$/US)									ESCOM 11% '93 yields 11.94% (.2044 US/SAR)			
2 year	3.91%						Denmark '94. yields 9.72% (7.0317 Dkr/US)		Credit Lyon '96 yields 8.05% (6.034 Ffr/US)						Finland '95 yields 8.45% (6.4651 FM/US)
3 year	4.33%			Bk. N.S. '96 yields 6.35% (1.7392 US/DM)		World Bk '96 yields 3.82% (115.59 US/JY)		Sweden '96 yields 6.88% (1.371 BP/US)			Ont. Hydro '96 yields 7.35% (1.3552 US/CD)		GE 11½% '95 yields 10.58% (1.9087 ITL/US)		
4 year	4.75%	NZ 10% '97 yields 7.22% (0.4852 NZ/US)		World Bk. '97 yields 5.72% (1.7036 US/DM)							RBC '97 yields 7.95% (1.4031 US/CD)		NIB 12⅜% '96 yields 10.76% (2.0037 ITL/US)		
6 year	5.40%				Australia '98. yields 4.70% (1.4624 US/SF)										
8 year	5.70%			World Bk '00 yields 6.50% (1.7441 US/DM)						U.K. '01 yields 7.53% (1.0296 ECU/US)				BIC V '01 yields 18.97% (2.5756 US/ARG)	
Spot Exchange Rate	–	.5326	.7092	1.6420	1.522	117.30	6.3065	1.474	5.5805	1.1812	1.2440	.2222	1.6030	.99995	5.935

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

Chart 13
Foreign Currency Bonds

Date: March 25,1993

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. ANNUAL YLD. TO MTY.	NEXT PAYMENT INTEREST DATE
DEUTSCHE MARK DENOMINATED				
BANK OF NOVA SCOTIA 5⅝% 07/05/96 RRSP eligible	97¼	98	6.35%	May 07
WORLD BANK 5⅞% 4/02/97 RRSP eligible	99 3/4	100½	5.72%	Feb. 04
WORLD BANK 9% 13/11/00 RRSP eligible	113.85	114.60	6.50%	Nov. 13
FINNISH MARKKA DENOMINATED BONDS				
REP. OF FINLAND 11% 15/6/95	104.12	104.87	8.45%	Jun. 15
ITALIAN LIRA DENOMINATED BONDS				
NORDIC INV. BANK 12⅜% 19/04/96	103½	104	10.76%	Apr. 19
GENERAL ELECTRIC 11½% 7/02/95	100 5/8	101 3/8	10.58%	Feb. 07
SWISS FRANC DENOMINATED BONDS				
GOVT. OF AUSTRALIA 5% 30/10/98	99 3/4	101 3/4	4.70%	Oct. 30
DANISH KRONE DENOMINATED BONDS				
KINGDOM OF DENMARK 9% 15/11/94	98.12	98.87	9.72%	Nov. 15
ECU DENOMINATED BONDS				
UNITED KINGDOM 9⅛% 21/02/01	108.45	109.20	7.53%	Feb. 21
BRITISH POUND DENOMINATED BONDS				
KGDM OF SWEDEN 8¾% 29/5/96	104 3/8	105 1/8	6.88%	May 29
FRENCH FRANC DENOMINATED BONDS				
CREDIT LYONNAISE 9½% 23/12/96	103.70	104.45	8.05%	Dec. 23
JAPANESE YEN DENOMINATED BONDS				
WORLD BANK 5¾% 7/8/96 RRSP eligible	105.20	105.95	3.82%	Aug. 07
CANADIAN DOLLAR DENOMINATED BONDS				
ONTARIO HYDRO 10⅞% 08/01/96 (semi annual)	108¼	109	7.35%	Jul. 08
EKSPORTFINANS 7¾% 5/11/97	99 3/4	100½	7.60%	Nov. 05
ROYAL BANK OF CANADA 9⅛% 7/1/97	102 7/8	103 5/8	7.95%	Jul. 07
SOUTH AFRICAN RAND DENOMINATED BONDS				
ESCOM 11% 31/10/93 (semi)	98.90	99.65	11.94%	Apr. 30
AUSTRALIAN DOLLAR DENOMINATED BONDS				
COMMONWEALTH BANK OF AUSTRALIA 14% 01/07/94	108 3/8	109 1/8	6.13%	Jul. 07
NEW ZEALAND DOLLAR DENOMINATED BONDS				
NEW ZEALAND GOV'T 10% 15/7/97 (semi)	109.80	110.55	7.22%	Jan. 15
ARGENTINEAN PESO DENOMINATED BONDS				
ARGENTINA BIC V FIXED/FLOATING 1/05/2001 callable in full on every interest date	88.78	89.53	18.97 IRR	4th day of mth.
U.S. DOLLAR DENOMINATED FIXED CONV. BONDS				
DATAPOINT CORP. 8⅞% 1/6/06 CV @ $18.11 p/sh (semi)	80	82	11.90%	Jun. 01
DICEON ELECTRONICS 5½% 1/13/12 (semi) CV @ $39.50 p/sh	33½	35½	17.69%	Mar. 01
BURNUP & SIMS 12% 15/11/00 (semi) CV @ $16.79 p/sh	90	92	14.19%	May 15
ATARI CORP. 5¼% 29/4/02 CV @ $16.31 p/sh	48	50	16.09%	Apr. 29
COEUR D'ALENE 6% 10/6/02 CV @ $26.56 p.sh	87½	89½	7.63%	Jun. 10
COEUR D'ALENE 7% 30/11/02 CV @ $15.87 p/sh	116	118	4.72%	May 31
U.S. DOLLAR DENOMINATED FIXED RATE BONDS				
FARM CREDIT CORP. 7¾% 10/06/96 RRSP eligible	108.60	109.35	4.53%	Jun. 10
U.S. DOLLAR DENOMINATED FLOATING RATE NOTES				
UNITED KINGDOM 24/09/96 3 mo. LIBID-⅛ (qtly) *callable @ 100	99.65	99.95	3¼%	Mar. 31

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

HOTLINE UPDATE

Tuesday, March 2:
The market letter is in the mail. In the current letter we recommend to liquidate all S&P put options if the cash S&P closes above 444. Tonight's close triggered the stop and thus we liquidated all S&P put options.

Friday, March 5:
This is a recap of recommendations for the week. On Tuesday, March 2 we recommended to liquidate all S&P put options. There are no other changes or new recommendations.

Tuesday, March 9:
Liquidate long March D-mark at the market. This replaces the .5955 stop, close only.

Flash update, Wednesday, March 10, 10:05 a.m.:
Sell June Canadian dollar at the market, currently trading at .7970. Place stops at .8050, close only.

Friday, March 12:
This is a recap of recommendations for the week. On Tuesday, March 9 we recommended to liquidate long March D-mark at the market, replacing the .5955 stop, close only. On Wednesday, March 10, via flash update, we recommended to sell June Canadian dollar at the market; place stops at .8050, close only.

Tuesday, March 16:
As recommended in our market letter of February we have used the current supply-driven rally to take profits in sugar and liquidate long positions as of today.

Friday, March 19:
This is a recap of recommendations for the week.
On Tuesday, March 16 we recommended to take profits in sugar and liquidated long positions.
Also, there are two new recommendations: Add to short positions in T-bonds by purchasing December 100 put options and sell June S&P 500 at the market; place stops at 455.00, good anytime.

Tuesday, March 23:
There are no changes or new recommendations.

Flash Update, Wednesday, March 24, 1:35 p.m.:
Liquidate long Japanese yen position at the market. The spot yen is currently trading at 117.15, June yen is currently trading at .8525.

Friday, March 26:
This is a complete summary since our last market letter dated February 28 of all liquidations of open positions and new recommendations that remain outstanding.

On Tuesday, March 9 we liquidated March D-mark at approximately .5999. On Wednesday March 10, we sold June Canadian dollar at approximately .7970 and placed stop at .8050, close only. On Tuesday, March 16, we took profits on our long sugar positions. May sugar opened at approximately 11.11. On Friday, March 19 we added to short T-bond positions by purchasing December 100 put options at approximatly .42. We also sold June S&P at approximately 449.00; stops were placed at 455.00, good anytime. On Wednesday, March 24 we liquidated long Japanese yen at approximately .8525.

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

Trading and Managed Accounts
All enquiries concerning trading accounts should be directed to:

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

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