

# FRIEDBERG'S

## COMMODITY & CURRENCY COMMENTS

Friedberg Commodity Management Inc.



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### Cheap money

Increasingly, monetary policy in the industrialized world is being shaped with a view towards reactivating growth. This is a seriously misguided and dangerous notion.

Traditional Keynesianism, with its emphasis on fiscal activism, exhausted itself sometime in the '80s, because permanent budget deficits produced unsustainable debt burdens. As governments dug themselves deeper and deeper into debt (see Chart 1), they were reluctantly forced to take painful fiscal adjustment measures, which in most cases entailed dramatic increases in tax rates. Increasing tax rates have not produced the intended results. Worse yet, by reducing incentives to work and shrinking disposable incomes, they have lowered further their economies' rates of growth.

The result is that the economies of Japan, Western Europe, and North America have slowed to a near standstill. Caught in a debt trap of their own doing, most OECD member countries are no longer able to use fiscal policy to stimulate growth. In short, they have become fiscally impotent.

Enter cheap money. From the days of John Law, more than two centuries ago, there always have been those who believe that cheap fiat money would stimulate economic activity. Twentieth-century central bankers, cloaked in respectable intellectual garb, still cling to this fetish. Could anyone with some common sense believe that a government agent distributing dollar bills at the corner of the busiest intersection of the city would durably stimulate economic activity? And if it worked for only a few weeks, wouldn't it be merely the result of deception, which would be exposed in short time?

Can anyone believe that costless pieces of paper can represent, let alone create, wealth? Members of the Federal Reserve do believe that as we have repeatedly documented over the past few years. Departing Fed Vice Chairman Alan Blinder recently suggested that the Fed may need to cut interest rates in the future because monetary policy was acting as a drag on economic growth. Current interest rate policy was called "slightly restrictive," although he saw a reasonably good chance that the Fed would "engineer" a so-called soft landing for the economy without a further change in monetary policy. He added that the central bank should be ready to alter policy if that is what is required to "stabilize the economy."

This past Thursday the UK's chancellor of the excheq-

uer lowered interest rates by a quarter point and justified the rate cut by pointing to the sluggishness of world spending. "The economy is continuing to grow," he said, "but at a rate which is clearly below trend. Activity has slowed more sharply in many of our major export markets, particularly in Europe, and this is contributing to slower growth at home."

No less a stalwart of hard money than the Bundesbank has caved in to the allure of cheap money, pushing interest rates down to their lowest levels in 8 years. The Bundesbank has ignored the recent acceleration in M3, choosing instead — as if it were really possible — to revive an economy that is in virtual recession (the GDP contracted in both the third and fourth quarters of last year) via low interest rates. The Bundesbank's actions have spread far and wide, allowing other countries to reflate.

Never has the world disregarded on such a massive scale, and with such intellectual force, the tenets of sound money. Money has become the instrument with which politicians

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Contributions by Albert D. Friedberg, Sholom Sanik, Peter O'Sullivan, and Mark Brandy.

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hope to produce jobs and create wealth. We have moved from a gold standard to a two-staged gold exchange standard, which culminated at Bretton Woods, and finally to a 100% fiat standard in the early '70s.

In the mid to late '70s central bankers made a valiant attempt to define and control money, but that has since disintegrated to the point that they no longer either know what money is or how to control it.

This is the terminal stage of an ill-fated monetary regime. Despite protestations to the contrary, central bankers no longer worry about inflation, targeting economic activity instead. Moreover, unable to define money and bewildered by fluctuations (cyclical? secular?) in the demand for money, central bankers fix interest rates at will, even though these very same gentlemen would never dream of fixing the price of wheat, computer chips, or wage rates.

It is interesting to note, that the simple and stable long-run relationship of M2, nominal income, and inflation broke down in 1990 and has not returned to its 30-year mean since.

This relationship was summarized by the trendless long-run average of M2 velocity, defined as a ratio of GDP to M2 (see Chart 2). The aberrant and puzzling behavior of M2 velocity is a warning to monetary economists who have praised the Fed for conducting an austere policy. A loss of confidence in money, triggered, for example, by a dramatic rise in the price of gold, could set the stage for an explosive rise in velocity.

With the genie — i.e., the huge amount of liquidity created in the past eight years — out of the bottle no amount of prudent monetary management can stop inflation from accelerating.

**CONCLUSION:** *The monetary authorities will, shamelessly, push cheap money until their economies "recover." The "recovery" will be short-lived and for the most part illusory. The rise in nominal GNP will be made up of little or no real growth and lots of inflation. Stagflation will have arrived. Interest rates will rise. Debt/income ratios will become unbearable. Money and government debt will become suspect. Financial assets will collapse. Gold will shine.*

Chart 1

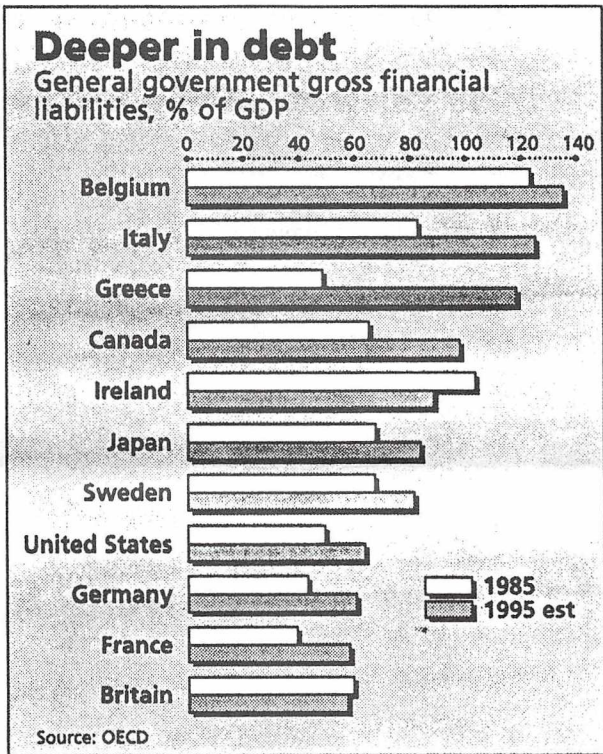
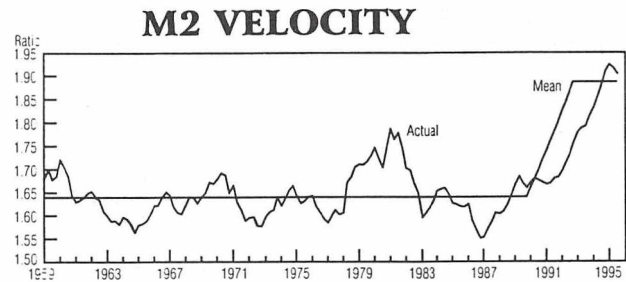
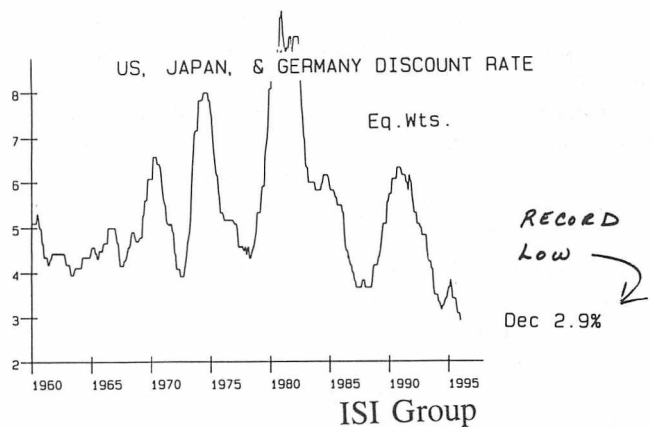


Chart 2



SOURCES: Board of Governors of the Federal Reserve System; U.S. Department of Commerce, Bureau of Economic Analysis; and the Federal Reserve Bank of Cleveland.

Chart 3



**GOLD**

# Very, very bullish

More of the same: Demand for physical gold reached a record 3,550 tonnes last year, well above the previous peak of 3416 tonnes seen in 1992, according to preliminary estimates by the Gold Fields Mineral Services consultancy organization. And guess how this increase in demand was satisfied? Continued sales by central banks and a surge in the sales of borrowed gold, as hedging by producers rose to its highest level ever.

It was announced that during November and December '95, JCI, the South African Mining House, sold the entire production of its Western Areas mining complex for the next 8½ years — a total of 7.3 million troy ounces, or 227 tonnes. That's roughly equivalent to the annual output of Australia, the world's third largest producer.

The ease with which the market absorbed this massive disposal suggests that the demand for physical gold, and thus the production deficit, is even larger than estimated by GFMS.

As we've explained in previous issues, the continuous shrinkage of the contango, or forward premium (see Chart 4) — the result of stubborn lease rates and falling Eurodollar rates — will at some point make further hedging operations less attractive. Physical demand will then overwhelm mine production, and prices will be pushed higher.

The effect will become quite dramatic when speculative investment joins the bandwagon. There is already some indication that this may be happening: Over the past 12 days, open interest on Comex has increased over 70,000 contracts, a 50% increase over the outstanding position at year-end.

Chart 5 shows analysts' forecasts for average gold prices in 1996. The forecasts are typical of analysts' tunnel vision and lack of imagination (and perhaps even lack of a good understanding of the dynamics of the gold markets). There is a high probability in our opinion that a breakout above 400/oz. will occur before the end of January. If it does not, no matter. Costs for owning forward gold are minuscule, while the costs of long-term options are ridiculously cheap. When the breakout comes, prices will quickly rise above the highest of our analysts' full year estimates, and then proceed to challenge the 1987 highs of \$500/oz.

Ultimately prices will challenge — and then exceed — the all-time highs of \$875/oz.

Obviously, we are very bullish.

**STRATEGY:** Remain long futures as per our flash update of January 10, 1996. Continue to accumulate six-month, one-year, and two-year calls, traded on the Comex.

Chart 4 – Gold - Forward premium

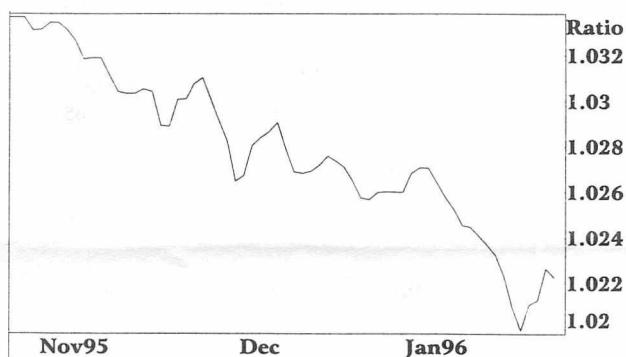


Chart 6



Chart 5

Analysts' Forecasts For Average Gold Prices in 1996	
	Gold Price
Bain & Company	395
James Capel	400
First Marathon Securities	410
Hambros Equities	398
T.Hoare & Company	410
Merrill Lynch	385
Ord Minnett	405
RBC Dominion Securities	400
Richardson Greenshields	395
SBC Warburg	410
David Williamson Associate	420
Rudolf Wolff	375
1995 Actual average	384.1
1994 Actual average	384
Source: Financial Times	

**CURRENCIES**

# Imaginary apprehensions

Market perceptions have changed radically over the past few weeks, affecting not only the dollar/DM rate but also the important DM/yen cross. In effect, Germany is believed to have entered a recession, because GDP has contracted for two consecutive quarters, while Japan has shown faint signs of recovery.

In addition, the strong DM has been blamed for the sharp fall in foreign manufacturing orders, creating the background "story" for a bear raid on the deutschemark. The DM has fallen against the US dollar, and more significantly, it has begun to weaken against the Japanese yen.

Imagined or real, and we suspect more the former than the latter, Japan's recovery has improved sentiment on the yen. The threat or possibility of future increases in interest rates may be deterring new yen selling, while rising stock prices are attracting a great deal of speculative capital.

The currencies of the three giants — the US, Germany, and Japan — seem to be in relatively close equilibrium, at least for the moment. All three nations are experiencing economic slowdowns, burdensome budget deficits, and weak

political leadership (that may be about to change in Japan). All three central banks have shaped monetary policy with a view towards reactivating their sluggish economy rather than maintaining sound money.

Admittedly, the German mark and more particularly the Japanese yen have appreciated a great deal in recent years, and some correction may be inevitable. They can hardly be characterized as overvalued, however, given the enormous productivity increases seen in their tradeable sectors. At the same time Germany's and Japan's large trade surpluses can easily be accounted for by their high rate of domestic savings.

On balance, then, we estimate that present rates are in reasonably close equilibrium. Sentiment has favored the US dollar, possibly because nominal short-term yields are highest there. This advantage disappears once rates are adjusted for inflation.

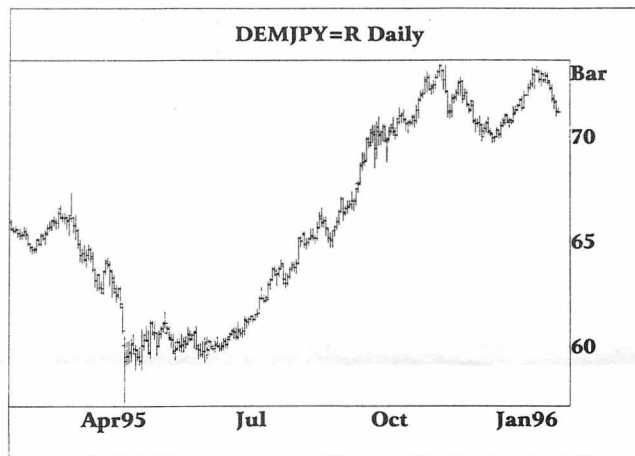
We suspect that US dollar's strength will be short-lived, because it is merely a product of imaginary apprehensions.

**STRATEGY:** *Remain neutral.*

Chart 7



Chart 8 – DM/¥ Cross



**STOCK INDEX FUTURES**

# Much ado about not too much

The US stock market continues to be remarkably resilient. Surprisingly good fourth-quarter earnings reports from key leaders in the technology and banking sectors have provided good support to the overall market. These have emerged as new leaders as well, something that was sorely missing after the carnage of the semi-conductor group. Earning gains, however, are narrowing: Of the 238 Standard & Poor's 500 Stock Index issues that have reported so far on the fourth quarter, 42.8% have exceeded expectations, while 38.4% came

in below forecast. Compare that with 56.4% and 32.2%, respectively, in the previous quarter.

Two interesting observations: Adjusted by inflation, the Dow Jones Industrial Average has just exceeded, if only slightly, the 1966 peak. A Dow Jones investor has thus preserved purchasing power (if he did not sell in the interim and incur taxes on gains) and earned an average of perhaps 4% per year through dividends. This is about what one could expect by purchasing an index-linked government bond in

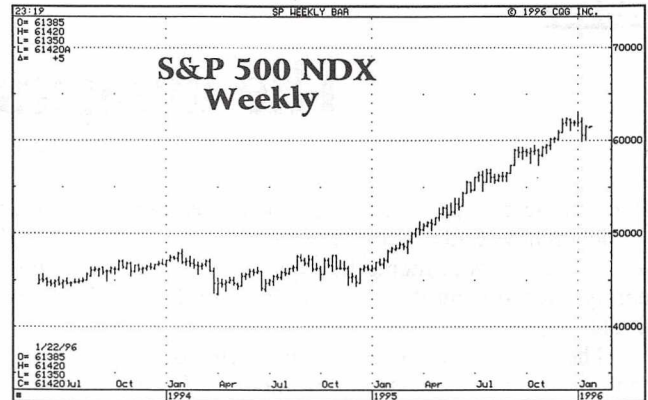
the UK, Canada, or Sweden. Much ado about not too much.

This does, however, tell us that this market is perhaps as dangerously overvalued as the 1966 peak, which turned out to be the prelude to an 8-year bear market that saw equity values fall by as much as 80% in real terms.

The combination of easy money and decent, though diminishing, earnings gains should provide continued support. The ability of the market to absorb heavy selling in one of its favorite sectors, and the failure of the market to gather enough downside momentum after breaking a one-year uptrend, speak of abundant liquidity and the forced search for new stories.

**STRATEGY:** *Remain sidelined.*

Chart 9



**HONG KONG**

**Machiavellian moves**

Here's an interesting set of propositions: Insiders (China interest and the large Hong Kong conglomerates) know that the Chinese takeover of Hong Kong will spell the end of one of the most prosperous economies in the world. Therefore, they would like to unload their holdings at the best possible price. Since their holdings are very large in relation to the Hong Kong stock market's capitalization, trading activity needs to increase. To accomplish this dramatic increase in activity, they must generate a great deal of excitement about future prospects.

The reader may object to this bit of Machiavellian logic, but we believe that it is exactly what is behind three recent events:

- On Jan. 11, the Chinese government said that it supported the construction of a new \$1.2 billion container terminal in Hong Kong, a project that China had previously blocked for more than three years;
- Lu Ping, China's top official on Hong Kong affairs, remarked a few days ago that he would welcome the return of the (British) Jardine Group to the local bourse;

- A Hong Kong investment arm of the Chinese government last week raised \$470 million by selling part of its stake in Hong Kong Telecommunications, the colony's second biggest company. It is rumored that the Chinese group is raising cash for an infrastructure project in China. How convenient.

This leads us to project sharply higher levels, on sharply higher activity, for the Hang Seng Index. Recently at 10073 — still down 20% from its all time high of 12599 in January 1994 — the index sports a not-excessive price-earning multiple of 15.1 and a dividend yield of 3.2%. It recently broke out of a 15-month reverse head-and-shoulder bottom (see Chart 10), measuring objectives of 13,000 and 18,000.

**STRATEGY:** *A convenient and highly leveraged play on this market can be obtained via call options on the Amex Hong Kong 30 Options Index, traded on the American Stock Exchange. This index reflects the Hang Seng Index very closely and should therefore show a similar price appreciation.*

Chart 10



## TAXES

# The dangers of tax shifting

by Mark Brandly

The income tax has become politically vulnerable. Some politicians have said we should replace it with a national sales tax. Yet, far from reducing the total tax burden, this would merely shift the burden around from individual filers to retailers.

Therein lies the danger in any discussion of new taxes, even if they are billed as "replacements." Historian Charles Adams sums up five thousand years of tax-reform fiascoes in simple terms: "how much of my taxes can I shift off to someone else?" If history repeats itself, we'll eventually suffer a national sales tax *and* an income tax, and total taxes will continue going up.

The income tax began in an attempt to shift the tax burden. It was supposed to replace the tariff. Many of those who supported the income tax believed that this was its primary virtue. But they were approaching the taxing problem the wrong way. The focus should not be on the *who* is taxed and *how*, but the total tax take and the size of the government it funds.

Today both confiscatory income taxes and trade restrictions (tariff and non-tariff) lower living standards and depress the economy. The very people who supported the income tax lived to suffer its effects. The lesson: work to make existing burdens as light as possible, diminish the overall costs of governments, and never shift taxes around from group to group.

Throughout most of our history, the individual income tax was considered contrary to American values. It violated the rights of property and gave the government license to spy. The income tax was regarded as a form of slavery in which the government laid claim to part of our labor time. That's why Marx and Engels, who wanted the "abolition of private property," called for "a heavy progressive or graduated income tax" as an appropriate inroad "on the rights of property."

The Founders, having suffered more than a century of imperial taxation, designed the US Constitution to limit the government's power to impose direct taxes. Even the anti-federalists, who believed that the Constitution created too big a central government, doubted that "any prudent congress," as one statesman said, would try to collect direct taxes.

No prudent Congress did. During the wartime "emergency" of 1812, Secretary of the Treasury A.J. Dallas proposed an income tax in a letter to the chairman of the Ways and Means Committee, but the proposal went no further.

Lincoln, who favored both tariffs and direct taxes, picked up the cause when he took office in 1860. The debt sat at \$75 million, and to raise money for another war, the president issued bonds, raised excise taxes, and doubled tariffs. At Lincoln's urging, Congress passed an income tax of 3% on incomes over \$800. The tax bill also contained the first loophole to encourage bond sales: the tax was cut in half for interest on government debt.

In the midst of anti-draft riots, Treasury Secretary Salmon P. Chase was reluctant to attempt to collect the tax. By 1862,

with the war stepped up and the debt passing \$500 million, the Northern Congress passed a second tax bill. It imposed a 3% tax on incomes above \$600, 5% on those above \$10,000, and 7.5% on incomes over \$50,000.

Wartime "patriotism" made it possible to collect the 1862 tax, and Lincoln became the first president to tax incomes. Predictably, Congress increased the rates two years later. But the income tax had not achieved political legitimacy in peacetime. After the war, a falling deficit allowed the anti-tax forces to win the day. Rates fell, and, after much debate, the entire tax was scrapped in 1872 — two years after it was statutorily set to expire.

Yet the popular image of the income tax had undergone a permanent shift. Rather than a form of slavery, people began to think of the income tax as a possible replacement for the tariff. The tariff had long contributed to sectional division. Northern industry favored the tariff as a means of protection from foreign competition. The South considered it exploitation, injuring trading relationships and forcing Southerners to pay high prices for manufactured goods. The tariff led to the nullification crisis and ultimately to the secession of the Southern states.

For that reason, people in the South and West were anxious to lower tariffs and pass an income tax that would strike back at the North. The relatively pro-South (and anti-Reconstructionist) President Andrew Johnson favored the income tax. He argued that it was the fairest way to collect revenue because it balanced the economic interests of the regions. (Note that the egalitarian argument was not part of the debate: progressive rates were seen as raising more revenue, not that they were more "fair.")

From 1874 to 1894, Congressional proponents of the income tax submitted 68 bills to restore it. All came from representatives of the South or the West who were determined that their regions should not bear the entire revenue burden. None of the bills made it to the House floor.

Underneath the surface of American politics, however, forces were at work that eventually broke down the resistance to the income tax. Northern business interests faced with economic slumps, lobbied for more protection. Meanwhile, tariff revenue began to fall, causing a growth in federal deficits.

In response to these budget trends, Congress *raised* tariffs after 1874. In 1890, the McKinley Tariff Act was signed by pro-tariff, anti-income tax president Benjamin Harrison. It increased the average rate on dutiable imports to an unconscionable 48%. Southern and Western resentment peaked, and catapulted the anti-tariff movement into the political mainstream.

The anti-tariff movement was now determined to shift the burden of exploitation to the exploiters themselves, the Northern money power. As the movement grew, for the first time, class-warfare populist rhetoric became part of the debate. The populist movements viewed the wealthy classes

("robber barons," the "bloated rich," the "money bags") as working with their minions in the government to victimize them with tariffs.

Even if ideologically unfocused, the impulses of these groups sprang from authentic grievances. The country's pro-tariff lobby did consist of a regional elite in league with government and banking, and this elite wanted the tariff precisely because it was all benefit and no cost. The populists were right about their enemies. But they were wrong in thinking the income tax would solve their problems.

In 1892, Grover Cleveland won the presidency on an anti-tariff platform, decrying it as "ruthless extortion" and urging its repeal. His campaign let unfortunate weight to the cause of the income tax. Adding to the pressure for new revenue, banking interests were clamoring for more government spending to bail out the victims of their fractional-reserve policies after the panic of 1893.

An income tax bill was attached to the tariff bill of 1894, and it easily passed the House. Fellow Congressmen carried House Speaker William Wilson on their shoulders in celebration. In an ominous sign of things to come, the Senate version of the bill also included an *increase* in the tariff. Believing that he had been betrayed, Cleveland refused to sign the bill, but it went into law without his signature.

Ninety-eight percent of the population was exempt under the 1894 income tax. But the momentum to raise it was growing because of a socialist-egalitarian argument: the rich benefit more from government, so they should also pay more. A year later, the Supreme Court struck down the income tax, on the Constitutional grounds that it was direct and disproportionate.

Unlike today's tax debates, high philosophical arguments were also part of the court's hearing. Populist attorney James C. Carter argued that the tax was a necessary weapon against the plutocracy. The plaintiff's attorney Joseph Choate stressed the sanctity of property rights.

The court predicted that "the present assault upon capital is but the beginning. It will be but a stepping stone to other, larger and more sweeping, till our political contests will become a war of the poor against the rich; a war constantly growing in intensity and bitterness."

The income tax had died at the hands of the court. Theodore Roosevelt revived the debate ten years later by trumpeting the glories of the income tax. Anti-tariff Demo-

crats were jubilant. In 1909, William Howard Taft took office in the middle of the tariff battle and a revenue shortfall.

The opportunity for a tax revolution was at hand. In an attempt to defuse the tariff debate within his party, Taft proposed a corporate "excise" tax (actually an income tax under another name) of 1%.

To quiet the Democrats, Taft also proposed a Constitutional amendment to get around the Supreme Court. "The Congress," the amendment said, "shall have the power to lay and collect taxes on income, from whatever source derived, without apportionment among the several States, and without regard to any census or enumeration." But neither he nor other members of his party thought the amendment would ultimately pass.

The strength of the anti-tariff, pro-income tax movement in the states had been drastically underestimated. In 1913, the 36th state ratified it, and the dreaded 16th amendment was put into the Constitution. When tariff revenues and business profits fell during World War I, the income tax option proved too tempting. The 1916 Revenue Act legislated income taxes separately from tariffs, and we got the first excess profits tax to boot.

These were relatively small taxes by today's standards. But we know what the future held. The income tax would later become the major source of political and economic coercion in American life. At the same time, the income tax had given protectionists cover to increase trade restrictions even though they raised no additional revenue.

Today individual taxpayers have had it with a tax that pillages as much as 40% of their income, including other payroll taxes. But just as in the period between 1874 and 1916, politicians are attempting to co-opt one anti-tax movement by suggesting we tax a new class of citizens: retail merchants.

Anti-tax forces should stick to reducing and eliminating existing burdens. Far more important than how a tax is collected, or who bears the burden, is the amount of total tax collected. All our efforts — intellectual and political — need to be devoted to reducing and eliminating this unbearable burden of the leviathan state.

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## WHEAT

# Not winded yet

The spot price of wheat has had trouble breaking through the \$5 mark with conviction for any length of time. So it may appear that this bull is out of breath. Not so. The latest US export data show a world in relentless pursuit of wheat.

In a resumption of export business patterns seen earlier this marketing season, wheat sales for the week ended Jan. 11 were 1.524 million tonnes, the highest weekly figure this year. This brings the total wheat shipped out of the US to 20.597 million tonnes, 13% above the same time last year. The buyers come out of hiding on any dip in prices, regardless of how high the price was.

Will the new crop of winter wheat replenish the emptying silos? The situation is not all that bright. In bull markets, farmers attempt to increase production to take advantage of high prices. Ultimately that new production brings an end to rising prices.

The market has already discounted this eventuality by pricing July wheat some 60¢ below the spot. The optimism for the coming crop may be a bit premature. Based on the USDA estimate of 52 million acres for the winter wheat crop and an early guess of 12 million for spring wheat, total acreage will be about 64 million acres. Last year 69.2 million

acres were planted, but only 61 million were harvested. A little loose arithmetic would tell us that if the same percentages were applied, only 56 million acres would be harvested. Of course, weather problems plagued last year's crop, and we couldn't possibly project bad weather. Nevertheless, the strong winds and below normal temperatures may have caused some drop in yield already.

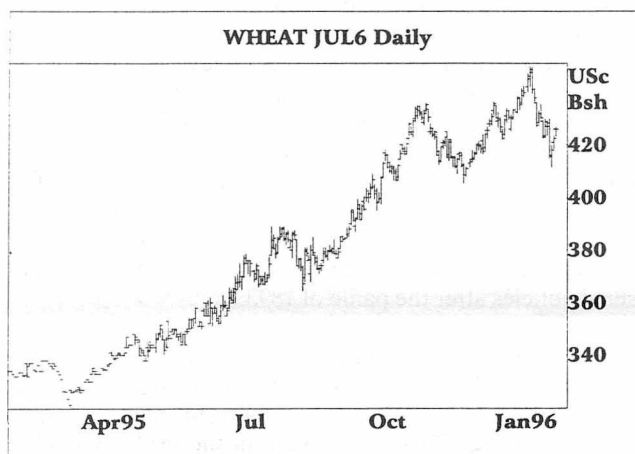
The net effect of a disappointment in the winter wheat crop might look like this: The USDA forecasts global ending stocks for 1995-96 at 97.5 million tonnes, which represents a 14.6% stocks-to-consumption ratio (17% last year). A loss in acreage of 8 million tonnes would leave an 89.5 million tonne carryout. That's a global 13.4% stocks-to-consumption ratio. Almost nothing left.

Grain stocks are dangerously low worldwide, and hungry countries rich with foreign reserves are eager participants in the market. For instance, the total Russian grain harvest was 63.5 million tonnes, 22% below last year's take. Russia may not be a good example of a rich country, but it's certainly a prime example of a hungry one. One way or another Russia and others will keep coming to market to buy what's left — and breathe new life into the bull.

**STRATEGY:** Clients have switched long March '96 positions to July '96, as per flash update of Jan. 16. Leave stops at 4.10, close only.

— Sholom Sanik

Chart 11 – Wheat



## SOFT COMMODITIES

### Soymeal

Traders have been anxiously watching weather reports to see how the dry weather will affect soybean crops. No, it's not May yet. In fact, if you hadn't noticed, it's January and the middle of winter. It is, however, spring in South America. South of the equator, it's planting season, and the weather watch is on.

The fields desperately need moisture for planting, and for a while, they were getting none. Weather patterns in South America have now returned to normal. But plantings have been delayed long enough ultimately to affect the crop size. It is far too early to tell how yields will turn out, especially since the last seeds in some areas did not make it into the ground until Jan. 20.

The USDA's Jan. 16 crop report carried a cautious and modest downward revision of Brazilian and Argentinian production, reflecting expectations for a drought-damaged crop. Spokesmen for some cooperatives said they expect declines in yields of up to 30% from last year. Although this is more than likely a tad overstated, the soy market can hardly afford to have any bad news from these vital exporters.

To illustrate how badly importers need every player in the field to have optimum yields, consider the US, the world's largest exporter of feedgrains. Ending stocks of all feedgrains are expected by the USDA to be 16.8 million tonnes, which represents less than 7% of consumption. This compares with last year's 16.7% stocks-to-consumption ratio.

While the most recent leg of rising prices in beans and meal was no doubt underpinned by the weather in South America, it is also clear that this market has demand-driven strength of its own. Unlike most years, when grain rallies fall apart as soon as raindrops hit the sidewalk in front of the Chicago Board of Trade, this market had its "return-to-normal-weather correction," and its prices remain poised right near

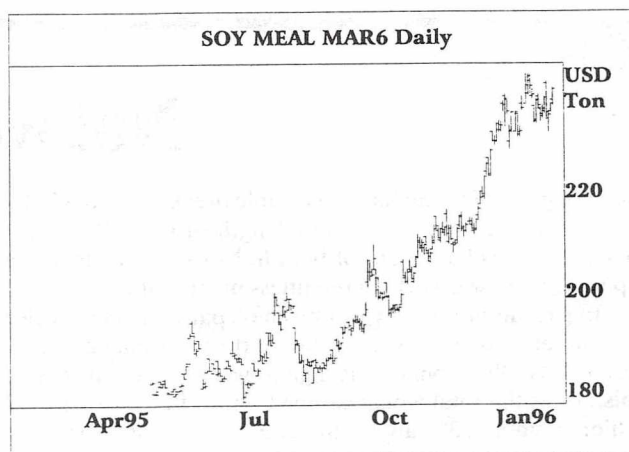
the highs.

Export business for US beans and soy products remains robust. Accumulated exports of beans are running almost 3% higher than the same time last year. Even though this statistic for meal continues to run behind last year's pace, recent activity supports our case for rising prices. For the week ending Jan. 11, for example, meal export volume was three times the previous week and more than double the four-week average.

**STRATEGY:** Remain firmly long. Stops have been raised to 217.00, basis March '96, close only.

— Sholom Sanik

Chart 12 – Soy Meal



## Cotton

The January USDA crop report again revised downwards 1995 US cotton production, this time to 17.9 million bales. Again, it came in at the low end of analysts' guesstimates. In addition, an uptick in exports to 7 million bales was a surprise. Together these factors will contribute to bring ending stocks down to 3 million bales, and represents a 16.85% stocks-to-consumption ratio. Suddenly, last year's dramatic bull-market-style ending stocks-to-consumption ratio of 13% is not that far off.

The 1994 US crop was planted on 13.3 million acres to produce a crop of 19.6 million bales. The historically high prices enticed farmers to increase acreage to 15.9 million acres in 1995. Insect and weather problems in the Mississippi Delta and West Texas, however, spoiled their plans. Yield was 540 lbs. per acre, down sharply from the 1994 yield per acre of 708 lbs. This explains, in large part, why the final crop estimate has dwindled down to such a disappointing 17.9 million bales.

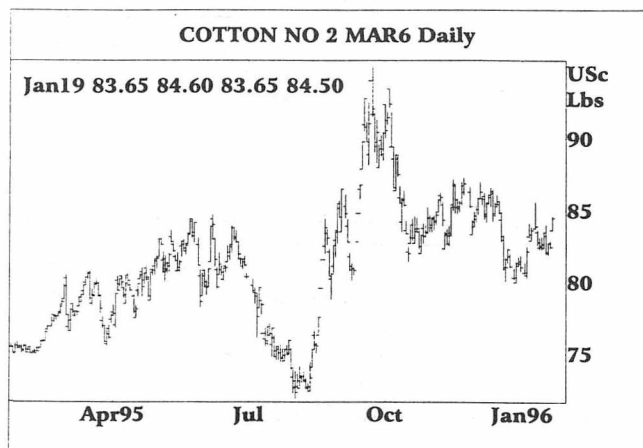
Looking ahead to this season, skyrocketing prices for corn and soybeans will cause planting intentions by farmers to effect a complete turnaround in favor of grains. In fact, some analysts estimate that cotton acreage will drop to as low as 14 million acres. If yields were to return to normal levels, one could expect a return to a 19 million bale crop. And improved insect control technology will save many an acre from infestation. Still, with such a sharp drop in acreage, the weather and the insects will have to behave almost perfectly to return to 1994 output levels. And when have they ever done that?

Recent export activity confirms the USDA hike in the export estimate. Foreign buyers, perhaps now convinced that prices have dropped as much as they're going to, are entering the fray, finally revealing the pent-up demand. Breaking the trend of earlier this season, US exports for 2 weeks in a row were up 38% and 35% respectively over the 4-week average. As the market becomes accustomed to a new price floor of 75¢ to 80¢, the bull will return.

**Correction:** Last month we reported that the Uzbekistan crop was half of what it was early in the decade. In fact, it is down only about 25% from that time.

**STRATEGY:** Buy May '96 at market. Place stops at 81.00, close only.

Chart 13 - Cotton



## Cocoa

Owning long positions in cocoa futures has at times held much allure over the past four years. After all, year after year of production/consumption deficits were bound eventually to eat away at stockpiles and cause a squeeze. Shortfalls could not be made up with additional plantings for the next season, because it takes seven years for the cocoa trees to bear fruit.

E.D. and F. Man greets the fifth year of deficit with its first set of estimates for the 1995-96 season. It calls for world production of 2.526 million tonnes against a grind of 2.592 million tonnes, for a deficit of 65,000 tonnes. It forecasts ending stocks at 946,000 tonnes, which brings us a very interesting 36.5% stocks-to-consumption ratio. Historically, such a figure would have been enough to ignite the bull. Nonetheless, the supply-side story is well-known and well-worn.

What has really accounted for the lackluster market has been uninspired demand. The bull looks to uncover the sweet tooth of the emerging economies of the Third World. Clearly, as disposable incomes in these countries grow, one can expect consumption of chocolate products to rise. In fact, although there are no reliable figures available, Asian and East European demand has been growing at 4.5% annually by some estimates, versus 1.5% for the rest of the world.

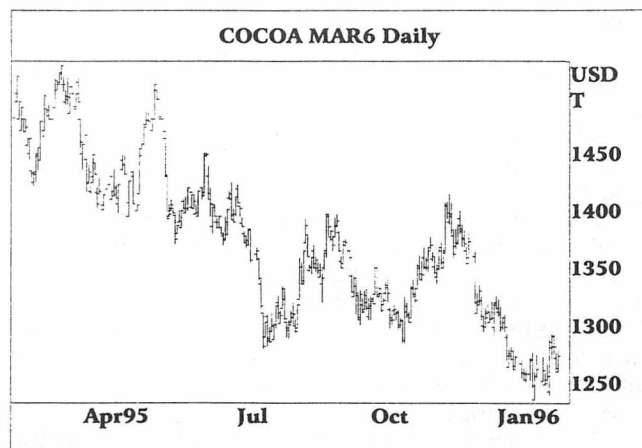
Some evidence of Asian demand can be seen in the Malaysian situation. For years, Malaysian production has been dwindling to such an extent that it no longer has enough beans to feed its processing factories. Rather than allow that end of the industry go idle, Malaysia imported 20,000 tonnes of beans last year, allowing it to cash in on the growing demand for chocolate.

The most exciting recent developments, though, come from the West. French imports of beans are up by 12.7% for the first 10 months of the year over the same period last year. The vital Dutch fourth-quarter grind was up 6.24% and, most importantly, above analysts expectations. Finally, the sluggish consumption trend in the US may have reversed, as the fourth quarter grind was up 8.29% over last year's fourth quarter.

**STRATEGY:** Clients are long, as per flash update of Jan. 18, risking 1235, basis March '96, close only.

- Sholom Sanik

Chart 14 - Cocoa



## Coffee

The double frost/drought that plagued Brazilian coffee plantations in 1994 has faded into a footnote in commodity market folklore. The price action even seems to support this treatment, as coffee has dipped below its level before the first frost. In addition, the coffee producing nations of South and Central America have failed embarrassingly in their attempt to boost prices with a retention scheme.

The USDA brought us the first official estimate of the 1996-97 Brazilian crop at 25.5 million bags, up dramatically from the weather-damaged 1995-96 crop of 16.8 million bags. But, there are a few flies in the ointment.

There is no known precedent for what happens to coffee trees in the year after they are hit by two killer frosts and a drought. Reports from Brazil tell us that in some regions, trees that by this time of the season usually are laden with green beans are still bare. It seems pretty clear that the USDA's estimate was based on a return to ideal conditions. Some private forecasts speak of a crop as low as 18 million bags. While a return to a normal crop in Brazil would bring production and consumption roughly into line, a spillover from the previous year's drought-damaged trees would cause a second year of serious deficit, drawing stocks down dramatically.

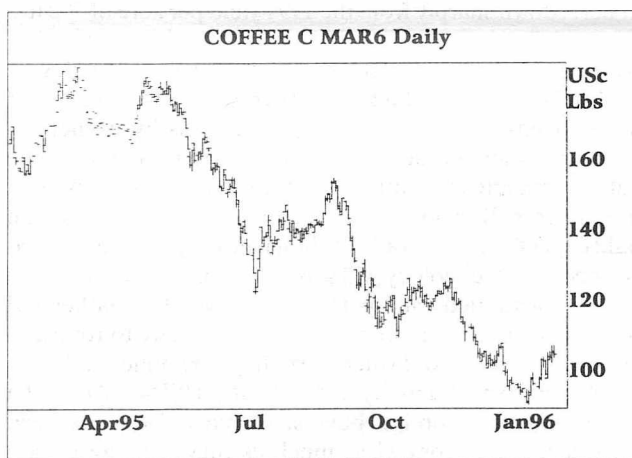
Consumption of coffee in Western countries has been tapering off over the years, so the demand must come from the developing world. And there is some evidence that this is happening: Brazilians consumed 11 million bags of coffee in 1995, compared with 9.3 million bags in 1994, a rise of 18%. Just as with other commodities, newly wealthy peasants the world over will take to this Western-style beverage. Of course, it will be served to them by Western companies looking to replace the market share they've lost in domestic markets.

Still, even with Western demand slowing, global consumption has held steady, while global production, with or without Brazil's disaster, has held steady or declined since the bumper crops of the early part of this decade. This has served to draw down stocks. Assuming the USDA's Brazilian estimate is fairly accurate and consumption remains constant at about 96.5 million bags, the stocks-to-consumption ratio will rise to 23%, still very bullish. Perhaps this is why, as we pointed out last month, both Arabicas in New York and Robustas in London remain in backwardation.

**STRATEGY:** Clients are long May '96 coffee at around 99.60, as per flash update of Jan. 10. Maintain stops at 92.00, close only.

— Sholom Sanik

Chart 15 – Coffee



## ARGENTINA

# Updates and corrections

In our article on Argentina last month ("Argentina: the great escape"), we argued that Argentina is "entering a virtuous cycle of economic growth, fiscal solvency, assured convertibility, rising liquidity, and falling interest rates." We also posited that the risk premium on peso debt should continue to shrink, given that Argentina has been able to weather the storm with its convertibility regime intact. We suggested that Argentine peso debt remain a strong hold.

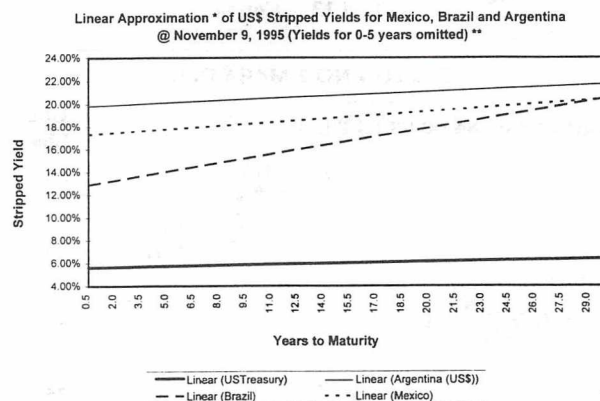
To support our recommendation, we featured a number of charts. There were, however, some omissions, which we'd like to correct. In particular, Charts 16 and 17 were missing a regression line for Argentine US dollar-denominated debt. We present the corrected graphs below along with more up-to-date charts.

Last month, we argued that Argentine yields were still too high and that fundamentally they should not only be lower but also that they should be below those of Mexico and Brazil as well. Chart 18 illustrates that Argentine stripped yields have in fact declined; however, the yield spreads relative to Mexico and Brazil have for the most part remained the same. We continue to look for a decline in yield relative to these two countries.

Peso-denominated debt versus US dollar debt is fea-

ured in Chart 19. And, as we predicted last month, we continue to see a decrease in the risk premium associated with the Argentine peso.

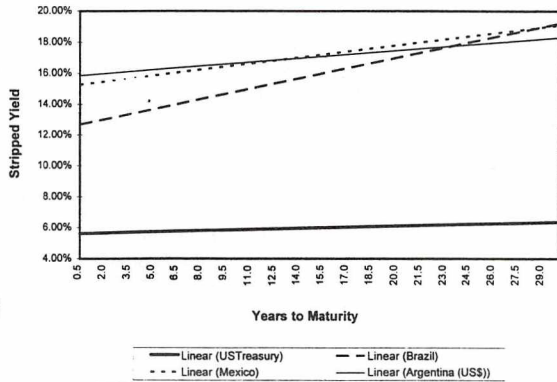
Chart 16



\* Linear approximation is a line of best fit between all the data points in a set.  
\*\* Brazil and Mexico did not have comparable instruments within 0-5 years.

Chart 17

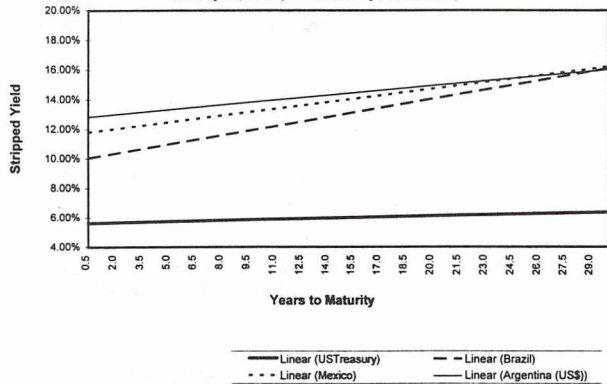
Linear Approximation of US\$ Stripped Yields for Mexico, Brazil and Argentina @ December 7, 1995 (Yields for 0-5 years omitted) \*



\* Brazil and Mexico did not have comparable instruments within 0-5 years.

Chart 18

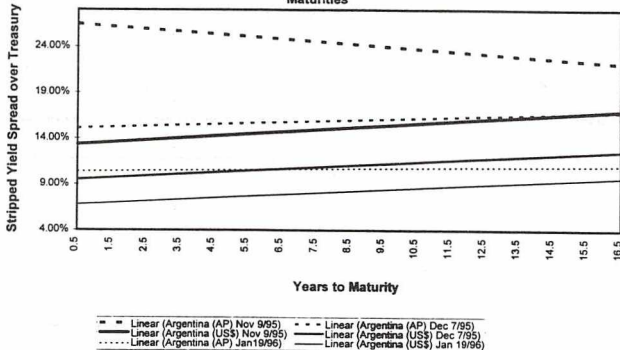
Linear Approximation of US\$ Stripped Yields for Mexico, Brazil and Argentina @ January 19, 1996 (Yields for 0-5 years omitted) \*



\* Brazil and Mexico did not have comparable instruments within 0-5 years.

Chart 19

US\$ and Argentine Peso (AP) Yield Comparison using Bonds with Identical Maturities



US\$ Debt - Bocon Pre 2, Bocon Pre 4, Bocon Pro 2  
 AP Debt - Bocon Pre 1, Bocon Pre 3, Bocon Pro 1

Chart 20  
Foreign Currency Bonds

DATE: January 19, 1996 We offer the following Bonds subject to change without prior notice: Minimum US \$5000 (CDN \$7000)

ISSUER / COUPON / MATURITY DATE	BID	OFFER	YTM	CURR.	NEXT INTEREST COUPON	PAYMENT DATE
<b>DEUTSCHE MARK DENOMINATED BONDS</b>						
Bank of Nova Scotia 5 5/8% 7/5/96 RRSP eligible	99.65	100.50	3.71			May-07
World Bank 5 7/8% 4/02/97 RRSP eligible	101.95	-	-			Feb-04
World Bank 7 1/4% 13/10/99 RRSP eligible	109.50	110.35	4.18			Oct-13
World Bank 9% 13/11/00 RRSP eligible	117.20	-	-			Nov-13
Kingdom of Denmark 6 1/8% 15/04/98	104.40	105.25	3.62			Apr-15
Argentina 8% 5/10/98	102.85	-	-			Oct-05
Bk. Foreign Eco. Affairs 7% 29/3/96	98.65	99.50	9.28			Mar-29
Kgdm. of Spain (6 Mo. LIBOR-1/16) 29/6/02 (semi)	99.30	99.60	-	3.6875		Jun-28
<b>CZECH REPUBLIC KORUNA BONDS</b>						
General Electric 10.5% 23/10/98	101.40	-	-			Oct-23
Nordic Inves. Bk 10.625% 10/11/00	101.15	102.00	10.06			Nov-10
<b>ITALIAN LIRA DENOMINATED BONDS</b>						
Nordic Inves. Bk 12.3/8% 19/04/96	99.40	100.25	10.32			Apr-19
<b>SWISS FRANC DENOMINATED BONDS</b>						
General Electric 4 3/4% 2/7/98	105.05	-	-			Jul-02
General Electric 4 1/2% 17/12/99	107.30	108.15	2.28			Dec-17
<b>DANISH KRONE DENOMINATED BONDS</b>						
Kgdm. of Denmark 9% 15/11/96	103.00	103.85	4.03			Nov-15
<b>ECU DENOMINATED BONDS</b>						
United Kingdom 9 1/8% 21/02/01	113.20	114.05	5.84			Feb-21
<b>BRITISH POUND DENOMINATED BONDS</b>						
Kgdm. of Sweden 8 3/4% 29/5/96	99.90	-	-			May-29
<b>FRENCH FRANC DENOMINATED BONDS</b>						
Credit Lyonnaise 9 1/2% 23/12/96	103.40	104.25	4.62			Dec-23
<b>JAPANESE YEN DENOMINATED BONDS</b>						
World Bank 5 3/4% 7/8/96 RRSP	102.25	103.10	-0.03			Aug-07
<b>CANADIAN DOLLAR DENOMINATED BONDS</b>						
Eksportfinans 7 3/4% 5/11/97	102.60	103.85	5.40			Nov-05
Royal Bank of Canada 9 1/8% 7/11/97 RRSP eligible	103.00	104.25	4.46			Jan-07
Ontario Province 10 5/8% 15/7/98 RRSP eligible	109.65	-	-			Jul-15
<b>SOUTH AFRICAN RAND DENOMINATED BONDS</b>						
ESCOM 11% 1/6/08 (semi)	85.20	86.05	13.33			Jun-01
<b>AUSTRALIAN DOLLAR DENOMINATED BONDS</b>						
Commonwealth Bk. of Australia 9 3/4% 15/5/96	100.40	101.25	5.27			May-15
<b>NEW ZEALAND DOLLAR DENOMINATED BONDS</b>						
World Bank 12.5% 25/7/97 (semi) RRSP eligible	106.50	107.35	7.26			Jan-25
New Zealand Gov't 10% 15/7/97 (semi)	102.40	103.25	7.63			Jul-15
New Zealand Gov't 8% 15/7/98 (semi)	100.75	101.60	7.28			Jul-15
Fletcher Challenge 10.75% 15/12/97 (semi)	103.20	104.05	8.38			Jun-15
Fletcher Challenge 10.15% 30/11/98 (semi)	103.40	-	-			May-30
Tranz Rail Ltd. 10% 15/10/99 (semi)	104.30	105.15	8.36			Apr-15
DB Group 7% 30/6/96 (semi) matures @ 85	86.05	86.90	2.80			Jun-30
Trans Tasman 9% 27/6/99 (semi)	90.75	-	-			Jun-27
<b>ARGENTINEAN PESO DENOMINATED BONDS</b>						
Bocon Pre 1: 1/4/2001	PAR VALUE 132.6138	93.00	94.75	15.69		May-01-97
<b>U.S. DOLLAR DENOMINATED FIXED CONV. BONDS</b>						
Burnip & Sims 12% 15/11/00 CV@16.79 p/ish (semi)	97.25	98.75	12.34			Nov-15
Atari Corp. 5 1/4% 29/4/02 CV@16.31 p/ish	48.25	49.75	19.97			Apr-29
Coeur D'Alene 6% 10/6/02 CV@ 26.00 p/ish	90.75	92.25	7.57			Jun-10
Glycomed 7 1/2% 1/11/03 CV@14.06 (semi)	77.25	78.75	12.11			Jul-01
<b>U.S. DOLLAR DENOMINATED FIXED RATE BONDS</b>						
World Bank 7 1/8% 27/9/99 (semi) RRSP eligible	105.70	106.55	5.14			Mar-27
Farm Credit Corp 7 3/4% 10/06/96 RRSP eligible	100.35	-	-			Jun-10
T.W.A. 12% 3/11/98 (semi)	90.75	91.60	-			N/A
<b>U.S. DOLLAR DENOMINATED FLOATING RATE NOTES</b>						
Kgdm. of Denmark 25/3/97 (Cost call, JY put)(semi)	91.60	-	-	8.0865		Mar-25
United Kgdm. 30/9/96 3 mo.LIBID-1/8 (qty),callable @100	99.84	100.14	-	5.4375		Mar-29
Bocon 1/4/01 (30 day LIBOR) starts paying May 1,'97	PAR: 124.0655	100.75	101.60	12.94		May-01-97
Argentina: Series L FRB 31/3/05, 6 mo. LIBOR+13/16 (semi)	73.5	75	12.53	6.8125		Mar-29

GOLD (in ounces, at market prices, can also be held in your bond account) client eligibility determined at point of sale.

Chart 21  
Recommended current portfolio allocations

- |                               |     |
|-------------------------------|-----|
| 1. Czech Koruna               | 10% |
| 2. PRE-1                      | 30% |
| 3. New Zealand (8%) '98 Gov't | 20% |
| 4. Fletcher NZ\$              | 20% |
| 5. Tranz Rail NZ\$            | 5%  |
| 6. World Bk (7 1/4%) '99 DM   | 15% |

**HOTLINE UPDATE**

**Tuesday, December 19, 1995:**

Good afternoon for Tuesday, December 19. There are no changes or new recommendations. The market letter is in the mail.

**Friday, December 22, 1995:**

Good afternoon for Friday, December 22. There are no changes or new recommendations.

**Tuesday, December 26, 1995:**

Good afternoon for Tuesday, December 26. There are no changes or new recommendations.

**Wednesday, December 27, 1995:**

Good afternoon for Wednesday, December 27, 5:30 pm. This is a flash update. We have two new recommendations. 1) Sell March S&P at the market, risking 625.00, good anytime. 2) Buy March Swiss francs and sell March Japanese yen as a cross, in equal dollar amounts. This would approximate 3½ contracts of Swiss long, against short 3 contracts of yen.

**Friday, December 29, 1995:**

Good afternoon for Friday, December 29. The following is a recap of this week's recommendations. On Wednesday, December 27, via flash update, we recommended to sell March S&P at the market, risking 625.00, good anytime. We also advised to buy March Swiss francs and to sell March Japanese yen as a cross, in equal dollar amounts, thus approximating 3½ contracts of Swiss long, against short 3 contracts of yen.

**Tuesday, January 2, 1996:**

Good afternoon for Tuesday, January 2, 1996. There are no changes or new recommendations. Happy New Year.

**Friday, January 5, 1996:**

Good afternoon for Friday, January 5. There are no changes or new recommendations.

**Tuesday, January 9, 1996:**

Good afternoon for Tuesday, January 9. We have one new recommendation. Raise stops on long March soymeal to 217.00, close only, from 210.00

**Wednesday, January 10, 1996:**

Good morning for Wednesday, January 10, 10:10 am. This is a flash update. Buy April gold at the market, presently trading at 402.00, placing stops at 391.00, good anytime.

**Wednesday, January 10, 1996:**

Good afternoon for Wednesday, January 10, 5:45 pm. This is a flash update. Sell March S&P at the market, risking 613.00, good anytime.

**Thursday, January 11, 1996:**

Good afternoon for Thursday, January 11, 1:00 pm. This is flash update. Buy May coffee at the market, presently trading at 99.60.

**Friday, January 12, 1996:**

Good afternoon for Friday, January 12. The following is a recap of this week's recommendations:

On Tuesday, January 9, we advised to raise stops on long March soymeal to 217.00, close only, from 210.00.

On Wednesday, via flash updates, we advised to buy April gold at the market, then trading at 402.00, placing stops at 391.00, good anytime, and to sell March S&P at the market, risking 613.00, good anytime.

On Thursday, January 11, March S&P opened at 603.70. We also advised to buy May coffee at the market, then trading at 99.60.

**Tuesday, January 16, 1996:**

Good morning for Tuesday, January 16, 11:00 am. This is a flash update. We have two new recommendations: Roll March wheat positions to July at market levels, placing stops at 410.00, close only, basis July. Also, place stops on long May coffee positions, at 92.00, close only.

**Tuesday, January 16, 1996:**

Good afternoon for Tuesday, January 16, 2:55 pm. This is a flash update. Liquidate long March Swiss francs at the market, presently trading at 85.38, and cover short March Japanese yen at the market, presently trading at 95.40.

**Tuesday, January 16, 1996:**

Good afternoon for Tuesday, January 16, 3:15 pm. This is our third flash update for the day. Cover S&P short positions at the market, presently trading at 607.70. At the end of the day we will recap all the flash updates from today.

**Tuesday, January 16, 1996:**

Good afternoon for Tuesday, January 16. The following is a recap of the three flash updates broadcasted today.

At 11:00 am, we advised to roll March wheat positions to July at market levels, placing stops at 410.00, close only, basis July. We also advised to place stops on long May coffee positions, at 92.00, close only.

Our second flash update at 2:55 pm, advised to liquidate long March Swiss francs at the market, then trading at 85.38, and to cover short March Japanese yen at the market, then trading at 95.40.

The third and final flash of the day at 3:15 pm, advised to cover short S&P positions, at the market, then trading at 607.70.

**Thursday, January 18, 1996:**

Good morning for Thursday, January 18, 11:00 am. This is a flash update. Buy March cocoa at the market, presently trading at 12.75, risking 12.35, close only.

**Friday, January 19, 1996:**

Good afternoon for Friday, January 19. This is a complete market summary since our last market letter dated December 17 of all liquidations of open positions and new recommendations that remain outstanding.

On Tuesday, January 9, we advised to raise stops on long March soymeal to 217.00, close only, from 210.00.

On Wednesday, January 10, via flash updates, we advised to buy April gold at the market, then trading at 402.00, placing stops at 391.00, good anytime. We also advised to buy May coffee at the market, then trading at 99.60.

On Tuesday, January 16, via flash updates, we advised to roll long March wheat positions, then trading at 4.85 into July then trading at 4.2525, placing stops at 4.10, close only. We also advised to place stops on long May coffee positions at 92.00, close only.

On Thursday, January 18, via flash update, we advised to buy March cocoa at the market, then trading at 12.75, risking 12.35, close only.

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