

FRIEDBERG'S

COMMODITY & CURRENCY COMMENTS

Friedberg Commodity Management Inc.



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The fruit of cheap money

For months, we have been warning that given the way monetary policy has been conducted in the main industrialized countries, serious economic troubles lie in store. We won't have to wait a great deal longer.

Fuelled by buckets of liquidity, grain and energy prices have soared, some to all-time highs. Admittedly, real factors have been at work, the gory details of which have been covered with great prescience by our commodity analyst since last fall. But monetary theory is clear in this respect: Where the supply of and demand for money are in equilibrium, relative price rises can be accommodated only by equal and corresponding relative price declines, so that absolute levels remain basically unchanged. This means that the spectacular price rises of grains and energy should have been compensated by declines in a number of other commodities, leaving the overall index unchanged. That is not what has happened

The producer price index for finished goods (PPI) accelerated at a 6.7% annual rate in March, up from a 3.5% annual rate for the first quarter and 2.2% for the past year. Even more dramatically, the Knight-Ridder Commodity Research Bureau Index (CRB), our industry's benchmark, has risen 11% so far this year, to eight-year highs, led of course by gains in the aforementioned grains and petroleum/natural gas but also by firming prices for a variety of other commodities such as sugar, cotton, and cocoa.

What is most remarkable about this mini-outbreak of inflation is that it has come at a time of soft economic activity in the US, Canada, most of Europe, and Japan. The Keynesian crews at the helm of the Fed, the BBK, and the BOJ must be hoping that this is a passing blip. They may also be taking comfort from the relatively well behaved pace of wages and the low near-term correlation between the consumer price index and the CRB.

They may be whistling in the wind.

It has been said that looking at wages is like driving and looking in the rearview mirror, and this is true in the initial stages of inflation. Labor is no more prescient than economists; one could hardly be surprised at their failing to anticipate an acceleration in the rate of inflation. But, one wonders, how likely is it that wages will remain as well-behaved in the face of rising bread, gasoline, and heating oil prices — especially when real compensation per employee during the '90s has been lagging productivity in the non-farm business sector by a highly significant 1.4% per annum (see Chart 2)?

Stagflation has begun to rear its ugly head. Raw material prices are rising. Productivity gains have slowed. Unit labor

Chart 1



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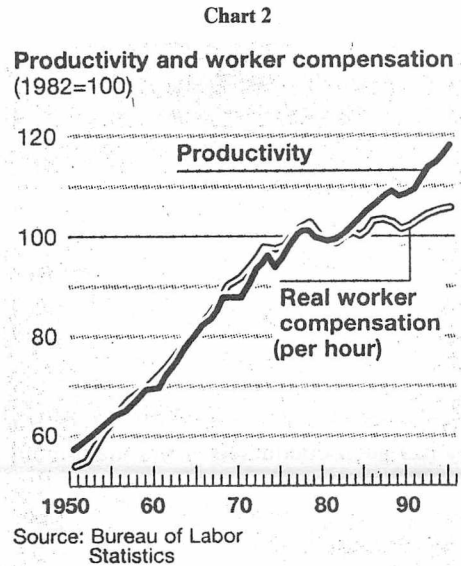
Contributions by Albert D. Friedberg, Ezra M. Friedberg, Laurie Mylroie, Peter O'Sullivan and Sholom Sanik.

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

costs are on the rise. Already at an annual rate of 3.6% per annum, they are likely to have a negative impact on corporate profits and eventually on production.

With the economy mushy, the Fed will be tempted to ease again and kick-start a new phase of real growth. It will be to no avail, because the economy is already straining under the weight of heavy consumer debt, a legacy of years of easy money. In the meantime, commodity prices will continue to rise, if only because stocks have been reduced to absurdly low levels.

Not only labor but producers and consumers too were lulled into believing that inflation had been conquered, and allowed inventories to disappear. From coffee and lead to petroleum and grains, shortages are threatening everywhere. Years of worry-free consumption are gone, rationing is in. Until, of course, stocks are re-built. Rising prices, teaches economics, are a desiderata. Inflation, as economics also teaches, is the fruit of cheap money.



INTEREST RATE FUTURES

Lethal stagflation

Has the Fed really been tight for the past few months as many Fed-watchers have argued? Banking liquidity measures don't support this contention, because bank investment continues to rise in the face of brisk loan demand. And yet, total bank reserves and M1 had shown slight contractions on a year-over-year and year-over-six month basis.

The answer to the puzzle seems to be found in sweep accounts. "Created to help banks economize on the reserves that are required to support demand deposits, these accounts involve the very short-term 'sweeping' of checkable deposits into money market deposit accounts. These activities are essentially invisible to the households that own checkable deposits, and so have little impact on true transaction balances. However, sweep activities can, and apparently do, significantly depress reserves and other narrow money measures.

"Sweep accounts began appearing on the monetary radar screen in 1994 and have grown in importance since then. From the first quarter of 1994 through the fourth quarter of 1995, the cumulative total of transaction deposits initially swept into money market deposit accounts has risen more than *sevenfold*. At the same time, the disparity between narrow-money growth rates before and after adjusting for sweeps has increased. Throughout most of 1995, unadjusted total reserves and unadjusted M1 actually declined, while adjusted measures grew." (Federal Reserve Bank of Cleveland, April 1996).

When adjusted for sweep accounts, both reserves and

M1 show positive rates of growth (see Charts 3 and 4). In recent weeks even the unadjusted figures have begun to pick up: Reserves have been growing at an annual rate of 9% and M1 at an annual rate of 4%. Rather than being tight, the Fed continues to be too easy.

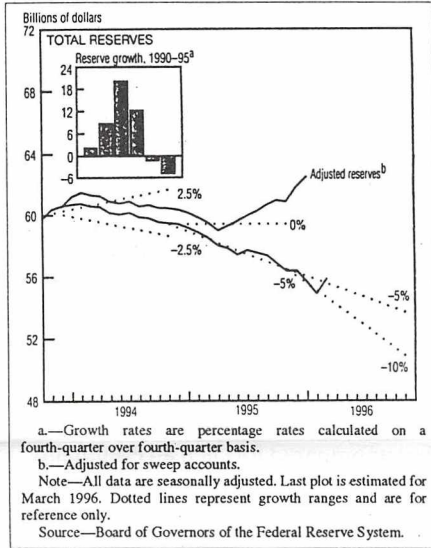
This does not augur well for bond prices. As discussed in our opening piece, an acceleration in inflation is now almost inevitable, led by rapidly rising commodity prices and rising unit labor costs. The exclusion of food and energy prices from CPI and the PPI is normally justified by their high volatility, which implies up and down fluctuations over relatively short period of time.

Since commodity prices will have to stay up for quite some time, however, to restore badly depleted stocks, they are certain to impact significantly the consumer basket of goods, particularly food and energy, and they will not be able to be ignored.

Last month we felt that the soft economic scenario will impel the Fed to lower rates, with constructive implications for the Treasury bond contract. While we still believe that there is a better than 50% chance that the Fed will lower Fed funds by up to 50 basis points, we no longer believe that the bond market will benefit. The coming period of stagflation will be lethal to bond prices.

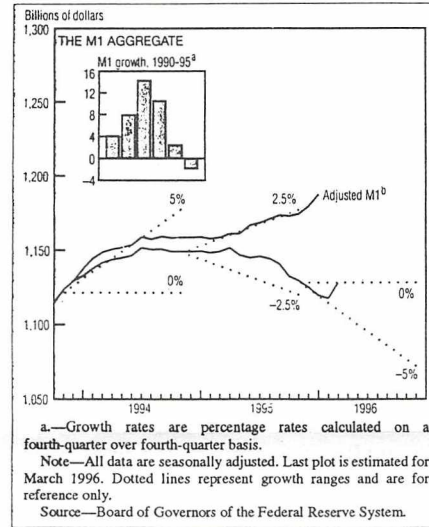
STRATEGY: *Initiate modest short positions on these levels with a view to adding on a scale-up to 112.00. Sell June '96 at the market.*

Chart 3



CONSENSUS April 19, 1996

Chart 4



CONSENSUS April 19, 1996

STOCK INDEXES

Recipe for a bear

The main ingredients for a protracted and severe bear market are in place. As discussed in our opening piece, stagflation has arrived. Rising commodity prices are sure to translate into higher inflation, which in turn should cause long-term interest rates to back up.

Bond-stock comparisons, already unfavorable (see Chart 5), will become even more so. At the same time, rising unit labor cost will shrink profit margins, which are already coming off multi-year highs. The downtrend in operating earnings' year-over-year gains continues (see Chart 6), removing the only antidote to rising interest rates.

The only plus to this market has come from the technical side. An important proprietary sentiment indicator of ours last month signalled an important advance. Curiously,

the advance did come in the broad market: The NASDAQ Composite Index just racked up its seventh consecutive record high, soaring 4.2% on the week and a stunning 12.8% on the year to date, with volume exceeding, in recent days, New York Stock Exchange volume by almost 50%.

Similarly, the small-cap Russell 2000 hit its seventh straight peak this Friday, gaining 2.75% on the week and almost 10% year to date.

In the meantime, the more senior Dow Jones Industrial and S&P 500 indexes have formed potential broadening top formations with the former displaying a classic head-and-shoulder top.

STRATEGY: *Conscious of the almost insurmountable odds of picking a top to one of history's most spectacular bull markets, we offer two strategies: Buy slightly out-of-the-money puts, and be prepared to liquidate them should the S&P 500 close above 675. Or, sell S&P 500 futures on any close below 625 basis the nearest contract.*

Chart 5

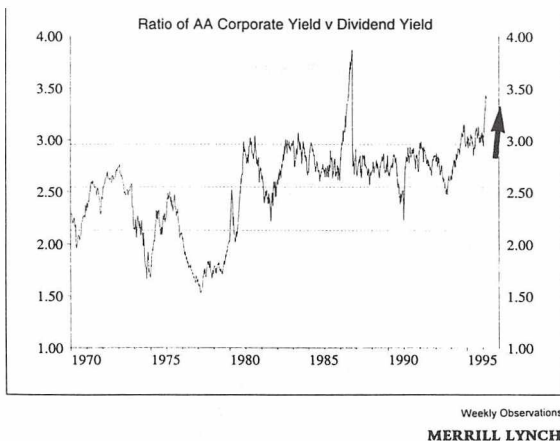


Chart 6

S&P 500 OPERATING EARNINGS	Y / Y %
1994 : 1	16%
1994 : 2	13
1994 : 3	13
1994 : 4	20
1995 : 1	21
1995 : 2	16
1995 : 3	21
1995 : 4	5
1996 : 1	0%

ISI Group

CRUDE OIL

The Saddam effect

A colder-than-normal winter caused a global stock draw of about 1.3 million barrels per day (b/d) during the first quarter of 1996, leaving underlying OECD company stocks extremely low (see Chart 7).

A possible breakthrough on Iraq-UN negotiations, allowing Iraq oil sales totalling US\$2 billion over 6 months for humanitarian purposes, sent crude prices down almost \$4.00 per barrel. At the last minute, however, the talks hit a deadlock and prices have begun to firm once again.

In this third round of talks, Iraq has been particularly annoyed at US and British interference. Clearly the Gulf Allies remain concerned about Iraqi military capabilities, particularly with regard to biological/chemical weapons and various long-range missiles, which still cannot be accounted for.

The Allies are obviously hoping that Saddam will fall before lifting full UN sanctions. Saddam must know this. He has had time to rebuild his army, as the following article makes clear.

But the population is starving, and discontent is on the rise. Time is not on his side. Feeling trapped, it is not inconceivable for Saddam to launch a mad and suicidal attack on his neighbours. In this hypothetical and terrifying scenario, the Kuwait and Saudi oil fields could be put out of action for

a long time; population centers could be held hostage to further biological/chemical attacks should the Allied command attempt to counter attack. Oil prices would soar well beyond the highs reached in the last Gulf war.

We assign a respectable probability to this event, because: a) Saddam Hussein is a madman; b) he is trapped, and he knows it; c) he needs to divert his own population's attention away from bankruptcy and starvation; d) he senses weakness and division in the Allied command (it is unlikely that it could ever be put together again); e) the market is on an uptrend but unprepared for such an eventuality (low stocks, high degree of complacency among the users, low implied volatility for deferred options), typical of major bull markets that feed on Murphy's Law.

Just as a UN deal would postpone, at least temporarily, such an attack, a failure to reach a deal could accelerate such a scenario. Based on the Arab lunar calendar, May 28 (11 Muhram) marks the anniversary of the 1990 Gulf war, a propitious time as ever for this madman to show the world that he has indeed won the Mother of all Wars.

STRATEGY: Long June '96 at 2115 as per Flash Update of April 8. Remain long, but pray for Saddam's imminent demise.

Chart 7

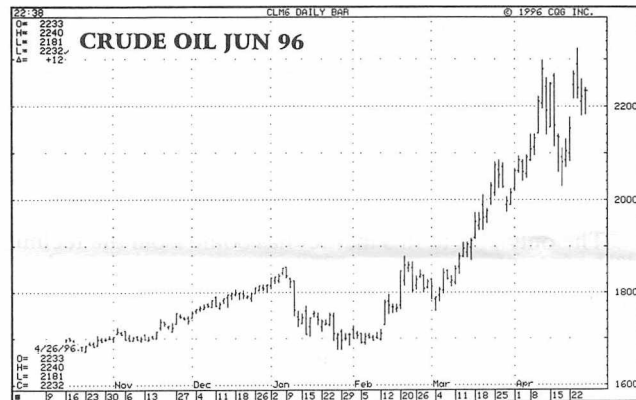
OECD - Total Company Stocks on Land 1994-96 (a)									
End:	Total Stocks (m bbls)			Stock Change (mb/d)			Days Supply (h)		
	1994	1995	1996	1994	1995	1996	1994	1995	1996
Jan	2493	2540	2399	+0.2	-0.1	-0.6	61	61	56
Feb	2390	2475	*2305	-3.7	-2.3	-3.2	61	62	57
Mar	2355	2419		-1.1	-1.8		62	62	
Apr	2387	2440		+1.1	+0.7		62	62	
May	2461	2481		+2.4	+1.3		63	63	
Jun	2483	2474		+0.7	+0.2		63	64	
Jul	2522	2553		+1.3	+2.5		63	64	
Aug	2552	2525		+1.0	-0.9		64	63	
Sep	2578	2524		+0.8	-0.1		65	62	
Oct	2568	2524		-0.3	-		63	60	
Nov	2568	2492		-0.1	-1.1		63	60	
Dec	2543	2417		-0.8	-2.4		62	57	

*Note: February estimated by EMC, on basis of preliminary data for USA/Europe.

(a) EMC series for total company stocks on land of crude oil, NGL and petroleum products (excluding strategic stocks), based on best available national/IEA data.
 (b) Stocks measured against oil consumption during next two months.

EMC - Energy Market Consultants Ltd

Chart 8



THE MID-EAST

Iraq, the forgotten danger

by Laurie Mylroie

It has been over five years since the 100-hour miracle in the desert that liberated Kuwait. But Saddam Hussein still holds on to his entire, very large stockpile of deadly biological agents. That vicious tyrant still has the capability to kill en masse, and his most likely targets would be the citizens of the countries that fought against him — America, Saudi Arabia,

and Kuwait, along with Israel.

The seriousness of the problem did not become evident until last summer. In July, after years of denying that it had had an offensive biological program, Iraq finally acknowledged to the UN that it had produced large quantities of anthrax and botulinum, two highly lethal biological agents.

But Baghdad denied that it had "weaponized" those agents and claimed that it had destroyed them in fall 1990, though it failed to produce any credible documents to support that claim. Baghdad's claim was not credible.

Then, the next month, Hussein Kamil, Saddam's cousin and son-in-law, defected to Jordan (he was subsequently murdered after foolishly returning home). Kamil had supervised the development of Iraq's unconventional weapons programs and his defection caused Baghdad to release a flood of stunning revelations about its unconventional capabilities. Above all, Baghdad acknowledged that its biological program was even vaster than it had admitted just the month before. It had developed the capability to deliver biological agents by bombs and missiles.

Furthermore, Iraq acknowledged that in the fall of 1990, when it had earlier claimed to have destroyed those agents, it was, in fact, stuffing them into bombs and missiles. Baghdad admitted that Scud missiles, equipped with biological warheads, had been deployed to air bases during the Gulf War, ready to fire at Israel and Saudi Arabia.

But Iraq still maintained that it had destroyed those biological agents. Baghdad's new account was that they were destroyed in the summer of 1991, again an undocumented claim. The assumption of the UN Security Council is that the materiel remains in Iraq. This assumption is bolstered by the fact that Baghdad has turned over little proscribed materiel since last summer.

Why does Saddam hold on to banned agents, blocking the lifting of sanctions and forgoing vast sums in oil revenues? Maybe Saddam holds on to that materiel because he views it as an option to use, if sanctions are *not* lifted. Saddam could use his residual unconventional capabilities to try to retake Kuwait and the oilfields of eastern Saudi Arabia. Or he might use them for terrorism in America in an effort to force the lifting of sanctions.

Indeed, two major defectors have warned that Saddam intends to use his residual unconventional capabilities. Gen. Wafiq Samarra, former head of Iraqi military intelligence, now based in Damascus, told me in a telephone conversation last September, "You must tell the allies that they have to destroy Saddam's biological agents." Kuwait, Saudi Arabia and "now Jordan," Gen. Samarra advised, were at risk.

A former adviser to Saddam told *The Guardian*, the British newspaper, much the same soon after Kamil's defection. He predicted that Saddam would not give up any more unconventional agents or their delivery systems. Rather, he

would brandish them in an attempt to get sanctions lifted through intimidation, and failing that "the end game will take place over Kuwait and the Gulf."

Yet the Clinton administration refuses even to acknowledge the danger. This is an election year, and it is preparing a laundry list of foreign policy "successes" for November. Iraq is high among them. Indeed, the State Department claims its Iraq policy is an "unqualified" success.

Those within the administration responsible for promoting the Middle East "peace process" resist any suggestion that America's diplomatic energy and political capital should go into a high-priority effort to take Saddam's biological agents away from him and otherwise get rid of him. This is the same mistake the US made before Saddam invaded Kuwait on Aug. 2, 1990. Back then, the State Department reassured everyone, "Saddam will not invade Kuwait." Now the diplomats say, "Saddam will not use his residual unconventional capabilities." Some people disagree. As one high-ranking Arab diplomat recently advised me, "Please don't tell me that there is anything that that man wouldn't do."

What should the West do? It's not enough to keep economic sanctions in place. The sanctions were never meant as an end in themselves. Their original purpose was to oblige the Iraqi regime — it was assumed that Saddam would be overthrown — to turn over the unconventional agents that had escaped destruction. But Saddam was not overthrown, and sanctions have not deterred him from retaining his stockpile.

So the US must muster the courage to confront the Bully of Baghdad one more time. Resolution 687, passed by the UN Security Council five years ago this week, required Iraq to report its prohibited weapons programs within 15 days. They were to be destroyed within another 90 days. Saddam is in gross violation of the cease-fire. The war is not over, and the US would be justified in using force to carry out the UN resolutions.

It may be protested that doing all this — taking away Saddam's residual unconventional capabilities and ousting him — is difficult. Indeed, it is. But the danger warrants an immediate response. Even in this election year, the administration must pause in its mad rush to take "risks for peace" all over the globe. The biggest risk of them all is that Saddam may use his residual unconventional capabilities. And we had better make sure that he does not.

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CURRENCIES

Change in the air

Sentiment is getting too one sided. Neither does the dollar deserve to be that strong nor the DM to be that weak. At the same time, in the face of unsolved and perhaps insoluble banking problems, the yen is too strong.

We may be nearing a change in trend.

STRATEGY: *Stand aside.*

GOLD

The last shakeout?

Sad to say, gold continues to act poorly.

Sentiment remains too bullish for a market that has failed to follow through on the much-vaunted breakout of the \$400/oz. level. The bullish sentiment of course is tied to the fact that commodity prices have been on a strong uptrend, with the CRB index registering 8-year highs.

But why indeed has gold not responded to the extraordinary strength in the grain and energy pits? A possible answer may have to do with the fact that producers have returned to their ways and have engaged once more in substantial forward sales. Anecdotal evidence speaks of new Australian and South African hedging programs, but aside from a confirmed sale of 390,000 ounces in February by Australia's Plutonic Resources, there is little in the way of hard evidence.

On the other hand, Belgium's sale of 203 tons, 31.77% of its total gold reserves, may have pressured the market, despite the announcement that the bullion went to another central bank. If, for example, the BIS was the buyer, the

announcement was technically correct, but it is entirely possible that the international bankers' bank resold it on the open market. In this case, the implications are quite bullish, because they speak of a market with great depth and resilience.

Given the continuing strength in commodity prices and the easy money climate fostered by the world's leading central banks, it is highly improbable that bullion will a) break 386, basis the nearest contract and/or b) spend another 3 years below \$400/oz. More likely, the tape will continue to look weak, prices will erode very slowly, and the Chinese torture will turn most believers into non-believers before prices can once again challenge the recent highs.

STRATEGY: *Holders of long-term call options should not be concerned; this may be the last shakeout before the grand move. Futures traders are out, having liquidated long June '96 positions around \$398 as per flash update on April 1.*

SOFT COMMODITIES

Corn

As prices rise mercilessly, fortunate owners of corn and other grains are becoming a tad nervous. The source of their nervousness: the "R" factor. At what price will feeding cattle, hogs, and poultry become unprofitable, forcing herd liquidation and ultimately quashing the demand that has fuelled soaring prices? Will the White House impose an embargo it did in 1971?

As far as herd liquidation is concerned, the signals are mixed. Cattle prices are plummeting, creating the illusion, at the very least, that a liquidation has commenced. The last USDA report, however, showed more cattle being placed on feed than expected, which would be bearish only for deferred contract months. The spot is taking the brunt of the price decline. Also, the report showed active marketings at a moderate pace, giving no indication of massive liquidation.

The likelihood of an embargo is small. In 1971 the US was in the thick of its cold war with the Soviet Union. It's easy to embargo an enemy. Today's customers are friends, and an embargo would certainly not be in the spirit of the age of GATT and other free-trade agreements. In addition it is an election year, and farmers with happy memories of these prices are likely to reward Bill Clinton whether he deserves it or not. They will punish him for disappointments as well, whether he deserves it or not.

Oh yes, the "R" factor: rationing. We believe in efficient markets. And those markets tell us that it is not happening —

yet. Each trading session brings new highs supported by domestic and export demand that just won't stop. We've examined production and carryover stock figures in recent months ad nauseam. Suffice it to say that our supposition that we will end the season with supplies that can be measured in single-digit number of days is now a reality.

Looking ahead to the new crop, things have changed. Already the USDA's planting intentions estimate for corn is outdated. Not only will corn be in theft of acres from cotton and soybeans but also a new source of acres has emerged. The pitiful shape of the hard red winter wheat crop has prompted farmers to tear up hopeless land and prepare it for planting corn. Some accounts say that as many as 5 million acres will be available.

Assuming normal planting and growing conditions and a return to normal yields, these acres could add as many as 500 million bushels of corn to the new crop. This would change the first estimate of the 1996-97 crop to 9.7 billion bushels from 9.2 billion bushels, perhaps giving some hope for replenishing stocks come autumn.

In conclusion with domestic and foreign buyers scrambling to get their hands on whatever few bushels of corn are left in the US, old crop prices will probably remain at these exorbitant levels, albeit with gut wrenching fluctuations and despite the outlook for the next crop. The market should not be assumed to be stupid in pricing new crop December at \$1.78 discount to May. Barring the unknown, the phenomenon

we've spoken of in the past — the process of bull markets giving birth to bear markets — is slowly unfolding.

Don't be fooled, we have not wavered in our commitment to the long side of the this market; we only want to make it perfectly clear that, more than ever, the spot months and the new crop months represent two completely different commodities and should be traded as such.

STRATEGY: *We're swimming in uncharted waters, and we don't know what lies beyond the next wave. In addition to watching for signs of rationing, keep an eye on the open interest. It has been declining, indicating the short covering process has begun. When the open interest stops declining and prices are no longer floating upwards, you'll know the end is near. For now, roll May corn into July, ride the next wave without stops, and keep posted. If you can't stand the heat, get out of the kitchen!*

Wheat

Getting right to the point, the prospects for a decent wheat crop in the US this year couldn't be worse. Nothing has gone right. The winter was harsh, and what wheat was not damaged is receiving little or no precipitation this spring. Strong export demand has drawn supplies down to the lowest level in decades, and it was assumed that a good crop would replenish stockpiles. The April USDA crop report showed US ending stocks at 305 million bushels, a downward revision from the previous month's estimate of 346 million bushels.

To illustrate how bad the situation is, let's look at Kansas, the nation's largest producer. Last year the state harvested 286 million bushels of hard red winter wheat. Last year's crop represented 13% of the total US wheat crop. Historically Kansas is counted on for producing about this ratio of the total crop. Increased acreage and better yields gave us an early estimate for the 1996-97 crop at about 63 million tonnes. Thirteen percent of that would be about 322 million bushels. Early estimates say that the Kansas crop will have trouble reaching 200 million bushels! Other states of the winter wheat belt look equally grim.

Although the spring wheat crop represents only 20.5% of the total crop, it was hoped that a good showing would take a bit of the pressure off the winter crop. So far, no luck there either. The wet weather is headed in the wrong direction. The northern spring wheat plains are getting cool, wet weather, which is delaying planting. Typically, about 20% of the crop should be in the ground by now, but only 4% has been sown to date.

The International Grains Council has provided the most recent estimate of the 1996-97 US crop at 2.403 billion bushels. If usage remained constant at 2.452 billion bushels and carryover stocks from 1995-96 were 305 million bushels, 1996-97 ending stocks would shrink to 256 million bushels, or 10% of consumption. This compares to the 10-year average of a 15% stocks-to-usage ratio. This is a conservative model, as

we could expect demand from emerging nations to grow and the real fate of the winter wheat crop could be a lot worse.

STRATEGY: *Re-enter the long side of July '96 contract on corrections equal to at least 2 limit moves from any high.*

Chart 9



Soybean oil

As grain prices continue to soar, the fear of feed grain rationing hovers over the market. If one could only find something to buy that was insulated from the "R" factor...voilà, soybean oil. Demand for feed grains is highly elastic, demand for vegetable oils, used primarily as a food additive and representing a small portion of the finished good, is far less elastic.

Production is a function not only of soybean production but of crush levels as well. Rationing of feed grains would actually be bullish for soybean oil because crushers would find it unprofitable to crush as meal demand drops, while at the same time, demand for beanoil would at the very least remain constant.

Although US exports dropped sharply from last year's 2.68 billion pounds to 1.55 billion, exports of beanoil cannot be viewed in the same light as grains themselves. Even last year's record export numbers represented only 17% of production, where soybean exports represented 33% of production. The key figure is domestic use, which rose 2% from the previous year to 13.1 billion pounds. When combined, domestic and export usage dropped by only 5%.

The world's second largest cooking oil market, palm oil, is very expensive in historical terms compared with soybean oil (see Chart 10). Rapeseed crops that produce the next most important oil, canola, are poor in Canada and across Europe.

In its March planting intentions report, the USDA estimated soybean acres at 62.4 million acres, down slightly from last year. We find complacency in these intentions, because domestic and foreign feedgrain demand continues to soar, but understandable in light of the fact that growing corn is far more profitable. With carryover stocks of 190 million bushels, representing 8% of total usage compared with last year's

stocks-to-consumption ratio of 14%, the crop must put in stellar performance, with no room for bad weather or increased demand.

STRATEGY: Raise stops to 25.95, basis July beanoil, close only. Raise stops to 7.50, basis November beans, close only.

Chart 10



Cocoa

The cocoa market has been the recipient of a steady flow of bearish news. It started earlier this month when the USDA claimed that the Ivory Coast crop would be 1.07 million tonnes, well above even the most optimistic estimates, putting the world crop at 2.71 million tonnes. This would represent a world crop 12% higher than the previous year. Consumption, or grindings, on the other hand will rise only 3%, definitely sending the market into surplus for the first time in 4 years.

The European Union adopted a proposal on the hotly debated issue of using fat other than cocoa butter in chocolate products, which would allow member states to continue to use 5% non-cocoa fat.

The US cocoa grind for the first quarter was a disappointment. Analysts had expected an increase of up to 10%, and it came in unchanged compared with the same period last year.

And yet, the market, as markets do, did the unexpected by putting together a handsome rally. Not only did the market make six-month highs but also it was accompanied by a rarity in this market, a tightening of the spreads. Not one of the agricultural markets that we trade has carryover stocks the size of those in cocoa, equal to about 40% of consumption.

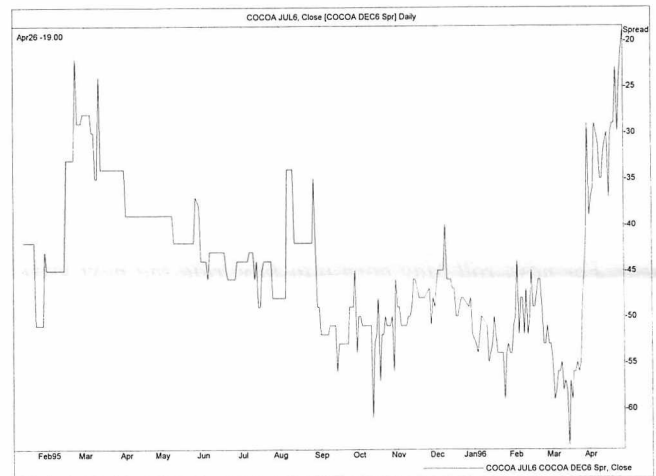
So it's little wonder that cocoa prices, even though we've been running production/consumption deficits for four years, are almost always in contango. The only way we will ever know if the deficits have actually eaten into stocks is when the market tells us. The spread between July and December has narrowed to 19 points from 60 only a few weeks ago (see Chart 11). It is said that European grinders having been playing the hand-to-mouth game and got caught short.

Watching whether an inversion develops as prices rise, something that has not happened in earnest since the market

bottomed in 1992, holds the key to determining whether this market is finally for real.

STRATEGY: Buy anytime the nearest contract closes above \$1400/ton.

Chart 11



Coffee

On April 12 the USDA surprised the market by revising its forecast for Brazilian 1996-97 production to 27.5 million bags, up 2 million bags from its December estimate. We're skeptical.

A few days later several Brazilian analysts challenged the estimate and showed their arithmetic. The disputed area, the Cerrado region, the USDA says, will produce 5.5 million bags; the Brazilians say it will yield only 3 million bags. The area has 145,019 hectares. The average yield per hectare is 21 bags, which in fact would show production of 3 million bags (145,019 x 21 = 3,045,399). To achieve the USDA's results, they claim, the yield would have to be 38 bags per hectare (145,019 x 38 = 5,510,722), which has never happened.

We spoke to the USDA and asked if they could clear up the apparent discrepancy, and they simply told us that they're always right and just couldn't reveal their counting methodology.

Last month we spoke of good crops in Colombia. However, it has since come to light that heavy rains during the flowering period have damaged the crop, and estimates have been revised downwards by as much as a million bags. Revising last month's model accordingly, ending stocks would be drawn down to 28.33 million bags, or about 29% of consumption, considerably below the average of the last 10 years.

Lest we forget, the scrooge of coffee, the frost season, is upon us. While the market has undoubtedly experienced the recent rally due to idle speculation of a frost (witness the sudden rise in open interest), the possibility and its consequences only make the bullish case more intriguing.

STRATEGY: Remain long, raising stops to 119.00, basis July '96, close only.

— Sholom Sanik

FRIEDBERG CAPITAL MARKETS

Venezuelan shock measures

One year ago had someone recommended we invest in Venezuela, we would have scoffed. Why invest in an interventionist country that is full of corruption and controls, has a weak currency, and simply lives off of its oil production? Yet one year later we observe that, enticed by a \$3 billion package of loans, Venezuela is beginning to deregulate and privatize its economy, providing us with another interesting opportunity in Latin America.

Finance Minister Mr. Luis Raul Matos Azocar recently announced the Venezuela Agenda, a stabilization plan that attempts to deregulate the economy, thus turning a new page in Venezuela's economic history. By far the most significant measure is the complete lifting of all exchange controls and the floating of the currency.

By floating the bolivar, Venezuela puts to an end currency controls, which had been instituted in June 1994. At that time it took 100 bolivars to buy 1 US dollar. Now, 2 years later, it takes almost 5 times that. The government has stated that it will use its considerable \$10 billion of foreign reserves to maintain the bolivar in the range of 450-500 bolivars to the dollar. After a flotation period the currency will go to a band system.

Another important goal of this plan is reducing the fiscal deficit from a staggering 7.5% of GDP in 1995 to a more manageable 1.7% of GDP in 1996. The necessary revenues will come from deregulating and privatizing a number of public companies.

Gasoline prices, hiked more than five-fold, are expected to increase revenue 1.5% of GDP. Additional revenues will be generated by raising utility prices and increasing taxes on wholesale goods.

In order to maintain social order and to make for a smoother transition, the government has also proposed 14 social programs, including a 70% wage increase.

Venezuela Investment Fund plans to sell its remaining stake in CANTV, the phone company, which could yield as much as \$6.5 billion over 3 years.

In return for these cuts, the IMF has pledged a \$1.4 billion stand-by loan. Both the Inter-American Development Bank (IADB) and World Bank have agreed to a loan package totalling another \$1.9 billion. It is hoped these plans will set the stage for economic growth in 1997 and help reduce inflation of 57% in 1995 and 80% (annualized) for 1996.

For 80 year-old President Rafael Caldera, this represents a striking about-turn. Just two and half years ago he declared he would not "get down on his knees before the International Monetary Fund." The big proponent of the plan is Mr. Teodoro Petkoff, a former leftist guerilla turned Finance Minister. (Ironically Caldera granted Petkoff amnesty in the 1960s). Petkoff announced the "shock measures," stating there was "no room for gradualism."

As is generally the case, Venezuela caused its own demise. By applying exchange controls, behaving in a fiscally irresponsible manner, and mishandling a banking crisis (among other things), the government got what it deserved: a country rife with corruption and in shaky financial condition. Having said that, it does appear that the plan addresses a number of most serious issues.

On an external basis, Venezuela compares reasonably well with its Latin American counterparts. According to 1996 forecasts, Venezuela is expected to have a debt-GDP ratio of 61%, compared with Argentina's 32%, Brazil's 22%, Mexico's 66%, and Peru's 51%. Venezuela's debt-exports ratio is projected at 185%, compared with Brazil at 266%.

In summary, by lifting exchange controls and addressing its most urgent financial problem, Venezuela appears to be making a serious attempt at a turnaround.

In our opinion, markets are overcompensating holders of Venezuelan debt for the sovereign risk. For purposes of comparison, we have attempted to isolate country risk, which takes the sovereign "stripped" risk compared with securities that have underlying collateral, often US government zero-coupon bonds.

For US dollar-denominated, floating-rate bonds with similar features, Venezuelan bonds yield 17.60% (for the DCB bond), compared with Brazil at 13.16% (EI bonds), and Mexico (2008 Aztec bonds) at 12.93% (as computed by J.P. Morgan on April 23). What this means is that one can capture 444 basis points (bps) over Brazil and 467 bps over Mexico by purchasing Venezuelan government bonds. So far, it looks like a good bet.

STRATEGY: *We are recommending the purchase of Debt Conversion Bonds (DCBs), which were restructured under the Brady Program. Unlike most Bradys, however, these bonds are not backed by US zero-coupon bonds. Denominated in US dollars, the bond matures December 18, 2007, and has a floating coupon of LIBOR (London Inter-Bank Offering Rate) of +7/8%, which is reset every 6 months. Reducing risk is the fact that these bonds amortize principal throughout the life of the bond (similar to the Argentina FRB bond). Current offering price is 66.10 for a yield to maturity of 15.85%. We are allocating to Venezuela an initial weighting of 5% in our recommended bond portfolio.*

— Ezra M. Friedberg

We take great pleasure in introducing Ezra M. Friedberg as a new contributor to Friedberg's Commodity & Currency Comments. Ezra is the son of Albert D. Friedberg, founder of Friedberg Mercantile Group. He holds an M.A. from Johns Hopkins University and is currently a broker/analyst at the New York Offices of Friedberg Mercantile Group, Inc.

FRIEDBERG CAPITAL MARKETS

Brady bond futures

Rather than taking a position on one country, it is sometimes desirable to trade one country against another. If you believe there is too much uncertainty in the absolute direction of sovereign debt prices yet feel strongly about the relative direction of yields between two countries, you would be much more comfortable with taking a position on the spread between the two countries. The success of this spread trade would depend on the relative movement between the long and the short position and not on the absolute movement of each.

Recently, the Chicago Mercantile Exchange introduced futures contracts that have specific Brady bond issues as the underlying securities. The Brady Bond Futures have a contract value of \$500 times the contract price, quarterly expiration beginning in March, and cash settlement. The introduction of these derivatives provides an alternative way of putting on relative value trades or spread trades (as referred to above) with attractive financing and the leverage characteristic of futures contracts. They also provide an avenue to increase or decrease exposure to a particular bond or sovereign.

The following provides some insight about how bond futures prices are calculated. You have two alternatives when considering an investment in a bond. You can hold the bond or hold a futures contract. When holding the bond rather than the future, certain costs (carrying costs) and benefits (income) will accrue. These costs and benefits are the only reconciling items necessary to make you *indifferent* between holding the bond and holding the future. Therefore, it follows that

$$\text{Futures Price} = \text{Price of Bond} + \text{Cost of Carry} - \text{Income from Bond}$$

where

$$\text{Futures Price} = F$$

$$\text{Price of Bond} = P$$

$$\text{Cost of Carry} = PD * r * t$$

$$\text{Income from Bond} = Ct$$

$$\text{Therefore, } F = P + (PD * r * t) - Ct$$

where

$$P = \text{clean price (quoted price)}$$

$$PD = \text{dirty price (clean price plus accrued interest)}$$

$$r = \text{cost of funding (assumed to be the repo rate)}^1$$

$$t = \text{\# of days to expiry of futures/360}$$

$$C = \text{annual coupon}$$

There are other variations of this model; however, the effect on the outcome is quite small. It is important to note that calculating these variables will differ among issues depending on the structure of the bond. For example, the Brazil C bond capitalizes half its coupon; therefore the dirty price (PD) must include both the appropriate amounts of accrued capitalization and accrued interest.

A consideration when participating in the futures market is the liquidity of the particular contracts of interest. Liquidity refers to the degree to which transactions can be quickly executed with little impact on prices. Statistics that indicate the amount of liquidity in a particular contract are open interest and volume. These statistics refer to the number of contracts outstanding at a certain time and those traded within a certain period, respectively. A lower degree of liquidity will increase the risk, because there is a greater probability of adverse price effects when liquidating the current position. Some Brady futures currently have relatively low liquidity; however, it is hoped that as investors become more educated with respect to these instruments, volume and open interest will increase.

We are particularly optimistic about Argentina and the opportunities it presents. Furthermore, we are encouraged when we compare it with other Latin countries such as Mexico and Brazil. Given this fact, a trading alternative would be to buy Argentina and sell Brazil.

To isolate the impact of changes in sovereign risk between the two, one would have to eliminate other influences on the bond prices, such as currency differences, US interest rate movements, and cash flow differences resulting from note structure. It is not possible to eliminate these entirely, although bond issues that are very similar would help eliminate most.

As an example, Argentina FRBs and Brazil EIBs are very similar in structure and duration, and are both denominated in US dollars. A long position in one and a short position in another should neutralize most of the effect on bond prices except those resulting from changes in sovereign risk perception, which is exactly what we want our trade to reflect.

STRATEGY: *Currently, Brazil EIBs are trading at a 13.32% yield, while Argentina FRBs are yielding 13.91%. We believe that Argentina's fundamentals, such as the strength of the banking system and the balance of government finances are far superior to those of Brazil. Consequently, we maintain that the FRBs should trade 250 to 300 basis points inside EIBs. We recommend a long position in Argentina FRBs against a short position in Brazil EIBs. At this point, however, using Brady futures for this position is not recommended, because EIB futures lack a comfortable level of liquidity. We will remain attentive to any changes in open interest and volume.*

— Peter O'Sullivan

¹Some models will assume a cost of funds equal to Libor; however, the cheapest source of funds available would be the repo rate, because it is a collateralized rate. When calculating the fair price for the futures, an investor with a higher cost of funds will calculate a higher fair price.

Chart 12 – Foreign Currency Bonds

DATE: April 26, 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. COUPON	NEXT INTEREST PAYMENT DATE
DEUTSCHE MARK DENOMINATED BONDS					
World Bank 5 7/8% 4/02/97 RRSP eligible	101.70	102.55	2.30		Feb-04
World Bank 7 1/4% 13/10/99 RRSP eligible	107.00	107.85	4.72		Oct-13
World Bank 9% 13/11/00 RRSP eligible	118.45	-	-		Nov-13
Kingdom of Denmark 6 1/8% 15/04/98	103.65	104.50	3.69		Apr-15
Argentina 8% 5/10/98	102.55	-	-		Oct-05
Kgdm. of Spain (6 Mo. LIBOR-1/16) 29/6/02 (semi)	99.68	99.98	-	3.6875	Jun-28
CZECH REPUBLIC KORUNA BONDS					
General Electric Cap. Corp. 10.5% 23/10/98	101.00	101.85	9.57		Oct-23
Nordic Inves. Bk 10.625% 10/11/00	101.40	-	-		Nov-10
SWISS FRANC DENOMINATED BONDS					
General Electric Cap. Corp. 4 3/4% 2/7/98	104.00	-	-		Jul-02
General Electric Cap. Corp. 4 1/2% 17/12/99	106.15	107.00	2.45		Dec 17 1996
DANISH KRONE DENOMINATED BONDS					
Kgdm. of Denmark 9% 15/11/96	102.05	102.90	3.41		Nov-15
ECU DENOMINATED BONDS					
United Kingdom 9 1/8% 21/02/01	112.20	113.05	5.91		Feb-21
BRITISH POUND DENOMINATED BONDS					
Kgdm. of Sweden 8 3/4% 29/5/96	99.65	-	-		May-29
FRENCH FRANC DENOMINATED BONDS					
Credit Lyonnaise 9 1/2% 23/12/96	102.75	103.60	3.64		Dec-23
JAPANESE YEN DENOMINATED BONDS					
World Bank 5 3/4% 7/8/96 RRSP	100.70	101.55	-		Aug-07
CANADIAN DOLLAR DENOMINATED BONDS					
Eksportfinans 7 3/4% 5/11/97	102.00	-	-		Nov-05
Royal Bank of Canada 9 1/8% 7/1/97 RRSP eligible	102.40	103.65	3.55		Jan-07
Ontario Province 10 5/8% 15/7/98 RRSP eligible	108.55	109.80	5.74		Jul-15
SOUTH AFRICAN RAND DENOMINATED BONDS					
ESCOM 11% 1/6/08 (semi)	73.40	74.25	15.86		Jun-01
AUSTRALIAN DOLLAR DENOMINATED BONDS					
Commonwealth Bk. of Australia 9 3/4% 15/5/96	100.10	100.95	-		May-15
NEW ZEALAND DOLLAR DENOMINATED BONDS					
World Bank 12.5% 25/7/97 (semi) RRSP eligible	104.05	104.90	8.22		Jul-25
New Zealand Gov't 10% 15/7/97 (semi)	100.40	-	-		Jul-15
New Zealand Gov't 8% 15/7/98 (semi)	97.95	98.80	8.60		Jul-15
Fletcher Challenge 10.75% 15/12/97 (semi)	100.20	101.05	10.02		Jun-15
Fletcher Challenge 10.15% 30/11/98 (semi)	99.30	100.15	10.07		May-30
Tranz Rail Ltd. 10% 15/10/99 (semi)	99.30	100.15	9.94		Oct-15
Trans Tasman 9% 27/6/99 (semi)	88.35	89.20	13.72		Jun-27
St. Luke 8.7% 1/4/99 (semi) CV @ 1.00 p/sh	122.35	123.35	9.16		Oct-01
ARGENTINEAN PESO DENOMINATED BONDS					
Bocon Pre 1: 1/4/2001	PAR VALUE 133.8043	100.25	102.00	IRR 14.33	May-01-97
U.S. DOLLAR DENOMINATED FIXED CONV. BONDS					
Burnup & Sims 12% 15/11/00 CV@16.79 p/sh (semi)	97.25	-	-		May-15
Atari Corp. 5 1/4% 29/4/02 CV@16.31 p/sh	61.75	-	-		Apr-29
Cosaur D'Alene 6% 10/6/02 CV@ 26.00 p/sh	98.25	99.75	6.05		Jun-10
Glycomed 7 1/2% 1/1/03 CV@14.06 (semi)	77.25	78.75	12.25		Jul-01
U.S. DOLLAR DENOMINATED FIXED RATE BONDS					
Queensland Tres. (Gold Bull) 2% 4/3/98	94.5	96.5	-		Mar-04
World Bank 7 1/8% 27/9/99 (semi) RRSP eligible	102.50	103.35	6.02		Sep-27
Farm Credit Corp 7 3/4% 10/06/96 RRSP eligible	99.90	-	-		Jun-10
T.W.A. 12% 3/11/98 (semi)	99.75	100.60	-		N/A
U.S. DOLLAR DENOMINATED FLOATING RATE NOTES					
Kgdm. of Denmark 25/3/97 (Gold call, JY put), (semi)	90.70	-	-	7.534	Sep-25
United Kgdm. 30/9/96 3 mo. LIBID-1/8 (qly), callable @100	99.86	100.16	-	5.2500	Jun-28
Canada Gov't 10/2/99 3 mo. LIBOR - 1/4 (qly), callable @ 100 RRSP eligible	99.50	99.80	-	5.05469	May-13
Bocon 1/4/01 (30 day LIBOR) starts paying May 1, '97	PAR: 125.7955	109.10	109.95	10.99	May-01-97
Argentina: Series L:FRB 31/3/05, 6 mo. LIBOR+13/16 (semi)	PAR: 99	75.75	77.25	11.82	Sep-30
Venezuela: DCB: 18/12/07, 6 mo. LIBOR+7/8 (semi)	65.25	66.1	15.85	6.5625	Jun-20

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

Chart 13
Recommended current portfolio allocations

1. Queensland (Gold Bull)	15%	4. Czech Koruna	15%
2. Venezuela DCB	5%	5. New Zealand Gov. (8%)	30%
3. St. Luke CV	10%	6. PRE-1	25%

HOTLINE UPDATE

Flash Update, Monday, April 1, 1996:

Good morning for Monday, April 1, 8:30 am. This is a flash update. Liquidate long June gold positions at the market, presently trading at 398.00, and liquidate long July silver positions at the market, presently trading at 558.00.

Tuesday, April 2, 1996:

Good afternoon for Tuesday, April 2. There are no changes or new recommendations. Our new regularly scheduled update will be Tuesday, April 9. Happy holidays.

Flash Update, Monday, April 8, 1996:

Good afternoon for Monday, April 8, 6:00 pm. This is a flash update. Buy June crude oil at the market, placing stops at 19.50, close only.

Tuesday, April 9, 1996:

Good afternoon for Tuesday, April 9. There are no changes or new recommendations.

Friday, April 12, 1996:

Good afternoon for Friday, April 12. The following is a recap of the last two weeks' recommendations.

- On Monday, April 1, via flash update, we advised to liquidate long June gold positions at the market, then trading at 398.00, and to liquidate long July silver positions at the market, then trading at 558.00.
- On Monday, April 8, via flash update, we advised to buy June crude oil at the market, then trading at 21.15, placing stops at 19.50, close only.

Tuesday, April 16, 1996:

Good afternoon for Tuesday, April 16. There are no changes or new recommendations.

Flash Update, Thursday, April 18, 1996:

Good morning for Thursday, April 18, 10:10 am. This is a flash update. Liquidate long June Canadian dollar at the market, presently trading at .7355, cancelling the .7200 stop.

Friday, April 19, 1996:

Good afternoon for Friday, April 19. There are no changes or new recommendations. The following is a recap of this week's recommendation.

- On Thursday, April 18, via flash update, we advised to liquidate long June Canadian dollar at the market, then trading .7355, cancelling the .7200 stop.

Tuesday, April 23, 1996:

Good afternoon for Tuesday, April 23. There are no changes or new recommendations.

Friday, April 26, 1996:

Good afternoon for Friday, April 26 This is a complete summary since our last market letter dated March 31, of all liquidations of open positions and new recommendations that remain outstanding.

- On Monday, April 1, via flash update, we advised to liquidate long June gold positions at the market, then trading at 398.00, and to liquidate long July silver positions at the market, then trading at 558.00.
- On Monday, April 8, via flash update, we advised to buy June crude oil at the market, then trading at 21.15, placing stops at 19.50, close only.
- On Thursday, April 18, via flash update, we advised to liquidate long June Canadian dollar at the market, then trading at .7355, cancelling the .7200 stop.

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