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The collapse of Wall Street and the lessons of history

Hernán Cortés Douglas

Trained economists rarely pay attention to excesses in financial markets. These episodes (economists call them bubbles) blow over most of the time without much of an effect on real economic activity. Two such extreme examples were the 1962 and 1987 crashes. In those rare instances when crashes precede economic depressions they are not viewed as having caused the depression. Rather, they are viewed as being as inscrutable as the Sphinxes, at best as testimonies to the markets' clairvoyance or collective wisdom. And yet, as the euphoria of a boom gives way to the pessimism of a bust, one ought to wonder what really happens to buying plans and business projects of overextended consumers and businessmen.

In what follows, Hernán Cortés Douglas, an economist of international repute, examines past periods of financial excesses and concludes that contrary to professional opinion, crashes and depressions are intimately connected.

Some years, like some poets and politicians and some lovely ladies, are singled out for fame. So economist John Kenneth Galbraith told us. The year 1929 was clearly such a year. Will 1997 be another?

A collapse of Wall Street, anticipating a contraction as virulent as the Great Depression, is a highly likely scenario. This article aims not at convincing but at warning. History teaches, however, that words of warning in a climate of euphoria fall largely on deaf ears. This is how it has been and how it shall be. The majority find a number of reasons to discard arguments based on the lessons of the past. History is, however, implacable with those who ignore its lessons.

All stock market crashes are unforeseen for most people, especially economists. This is the first lesson of history.

"In a few months I expect to see the stock market much higher than today." Those words were pronounced by Irving Fisher, America's distinguished and famous economist, Professor of Economics at Yale University, 14 days before Wall Street crashed on Black Tuesday, October 29, 1929.

"A severe depression such as 1920-21 is outside the range of probability. We are not facing a protracted liquidation." This was the analysis offered days after the crash by the Harvard Economic Society to its subscribers. After continuous and erroneous optimistic forecasts, the Society closed its doors in 1932. Thus, the two most renowned economic forecasting institutes in America at the time failed to predict a crash and depression were forthcoming, and continued with their optimistic views, even as the Great Depression took

hold of America.

Irving Fisher lost \$140 million (in today's dollars) in the stock market crash, according to his biographer son, Irving Norton Fisher. Fisher was a man of many talents, a great economist, an excellent theoretician, one of the founders of econometrics, and a pioneer in index number analysis. He was also the inventor of the kardex index file system, which he sold to Remington Rand for millions, and subsequently lost in the crash.

John Maynard Keynes, the most famous British economist, who made fortunes in the financial markets for himself and Cambridge University, lost £1 million (in today's pounds) in the crash, according to biographer Professor Skidelski.

With two exceptions, no academic economist forecast the crash of 1929 and the following depression. Even more dramatic is the fact that in 1988, six decades after the crash and depression, Kathryn Dominguez, Ray Fair, and Matthew Shapiro concluded in the *American Economic Review* that employing sophisticated econometric techniques of the late 1980s and even using data unavailable in 1929, the Great Depression could not have been forecasted.

In this issue

- 4 Currencies**
Private investors finally like US\$
- 6 Italian Lira**
An interesting bear speculation
- 7 Potpourri**
Gold, S&P 500
- 8 Copper**
Room for speculation
- 9 Soft Commodities**
Cocoa, corn, soy complex
- 11 Friedberg Capital Markets**
Foreign currency bonds
- 12 Hotline Update**

Contributions by Hernán Cortés Douglas, Albert D. Friedberg and Sholom Sanik.

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

Rudy Dornbusch, Professor of Economics at M.I.T., has said that the Great Depression is, to macroeconomics, a mysterious and unexplained phenomenon.

A financial collapse has never happened when things look bad. This is another lesson of history. On the contrary, macroeconomic flows look good before crashes. Before every collapse, economists say the economy is in the best of all worlds. Everything looks rosy, stock markets go up and up, and macroeconomic flows (output, employment, etc.) appear to be improving further and further. This explains why a crash catches most people, especially economists, totally by surprise. The good times are invariably extrapolated linearly into the future. Is it not perceived as senseless by most people in today's euphoria to talk about crash and depression?

The political mood is also optimistic. In November 1928, Herbert Hoover was elected President of the United States in a landslide, and his election set off the greatest increase in stock buying to that date. Less than a year after the election, Wall Street crashed.

Similarly today, with a Democrat in the White House and Republicans in control of Congress, the perception is that they ensure the continuation of the best of times. As a result, the November 1996 election set off the greatest increase in Wall Street to date.

All stock market collapses occur with a heavily indebted private sector, history also shows. Indebtedness is a sign of confidence. The lender trusts that the debtor will be able to pay the principal and interest on time. The debtor — if not a crook — believes the same. He does not have the money now, but he will have it later.

Accelerated overindebtedness is, correspondingly, a sign of overconfidence, and in the latter stages, of euphoria. It is too easy, after the fact, to label as irrational many actions undertaken in a stage of overconfidence. These actions appeared perfectly sound to the decisionmakers at the time of the decision. For example, according to *The Wall Street Journal* last November, an American regional bank lent 100% of the price of a house to a person without stable income, recently divorced, and whose previous house had been foreclosed. In this stage, you and I may call it overconfidence. *The Wall Street Journal* used it as an example of the emerging "brave New World of mortgage financing." Historians will call it something else. "Irrational exuberance" perhaps?

Experience also shows euphoria is rampant before the crash. "This time is different" is euphoria's motto, even though signs of disequilibrium appear, warning of danger ahead. In 1989, for example, price-earnings ratios of Japanese stocks climbed to ridiculous levels as the Nikkei index soared to 39,000. Despite numerous warning signals, many pundits and analysts continued to favor Japanese investments, arguing that Japanese accounting systems were "different" and that central banks now know how to keep an economy depression-proof. "This time is different," was the rallying cry. But, as we now know, the Japanese stock market subsequently collapsed by 60%, and a virulent and protracted recession ensued.

Psychologists refer to this phenomenon as "cognitive dissonance," which pertains to the denial of the warning signs, the rationalization of risky decisions, and inaction. We do not want to see, we do not want to know; we rationalize and justify the unjustifiable.

Euphoria leads to carelessness. In America, at present,

the ratio of dividends to price is lower than the interest rate on bank deposits. Today it is less than 2%, indicating that stocks are more than 45% more overvalued than in 1929 (when the ratio was 2.89%). This means a bank deposit is providing a higher return at a sizably lower risk than stocks. Why buy stocks then? Buyers of stocks confidently expect to sell to someone else at an even higher price. If they cannot, they lose. In financial circles, this is called the "Greater Fool Theory." And again history teaches us that this theory makes its grand entrance, time and time again, before a crash.

It is said that Henry Ford was taking the elevator to his penthouse one day in 1929, and the operator said, "Mr. Ford, a friend of mine who knows a lot about stocks recommended that I buy shares in X, Y, and Z. You are a person with a lot of money. You should seize this opportunity." Ford thanked him, and as soon as he got into his penthouse, he called his broker, and told him to sell everything. He explained afterwards: "If the elevator operator recommends buying, you should have sold long ago."

Euphoria leads to those unacquainted with financial markets to enter in the last leg of the boom. And that's where they lose everything. About 88% of all the money now in mutual funds has arrived there in the past 6 years. These new investors have never been through a correction of even 10%. Most new entrants into the stock market are totally inexperienced. More money went into mutual funds in the first half of 1996 than in the whole year of 1993, the previous record year. At the same time, 1996 shows record highs in personal bankruptcies and in credit card delinquency rates. Are consumers going into debt simply not to miss out on the stock market boom?

The capitalized value of US stock markets is now equal to America's GDP for the first time in history. Ominously, history teaches us that every time Wall Street's capitalized value exceeds not 100%, but 70%, of GDP, a crash soon follows.

The collapse of the stock market is the warning, the signal, that the loose-reined optimism, the euphoria, is reverting with a vengeance. All projects deemed excellent under euphoria turn into mistakes when the new pessimism prevails.

All great crashes were followed by economic depressions. In the three centuries of stock market data available, there have been three major collapses: the crash of the London stock market in 1720, followed by an economic contraction lasting several decades, and the collapses of 1835-40 and 1929-32, also followed by economic depressions.

The first recorded major bear market took place before the United States was born. It started in 1720 with the crash of the London stock market, and is better known as the South Seas Bubble. In only 2 years, 91% of the stock issues went off the board. The issues not only collapsed in price — they also disappeared.

The crash anticipated a bear market that lasted 64 years, until 1784, and also anticipated a protracted economic contraction. In the 2 decades after 1720, UK industrial production increased less than 0.5% per year, and less than 1% per year in the following 4 decades.

Since 1784, stock prices have been in a secular bull market. It has lasted over 210 years, coinciding with the existence of the United States as a nation. In this period, two corrections took place: in 1845-40 and 1929-32. Both antici-

pated two important economic contractions.

Overconfidence, excessive optimism, and euphoria lead to overindebtedness, unwise investments, carelessness, fragility, and a final collapse. This is another lesson of history. Are not these disequilibria leading to financial crashes and depressions the same ones economic theory has warned are the ultimate causes of crises — the economic theory we learned from Wicksell and von Mises, from Pigou, from Fisher, and from Hayek?

Ludwig von Mises, another Austrian, also anticipated a worldwide depression in the 1930s, as reported by Fritz Machlup, Mises' assistant at the time. Mark Skousen also tells us Mises' wife, Margit, wrote in her husband's biography that he rejected in the summer of 1929 a high position in Credit Anstalt, one of the largest banks in Europe at the time. His explanation was simple: "A great crash is coming, and I do not want my name in any way connected with it." Less than two years later, Credit Anstalt was bankrupt.

Excessive optimism in the last leg of the boom leads to unwise investments being made, both real and financial. This is another lesson of history. These investments appeared justified in a context in which everything is going up and every mistake can be corrected and any indebtedness can be subsequently handled with higher incomes and wealth. Often these expected increases are paper-wealth increases and are not realized before the crash — especially for the latecomers to the stock market who join when all prudence advises staying away.

The increasing indebtedness of corporations, households, and the government, as in America today, generates an increasingly fragile financial sector and a highly vulnerable economy. Debt in the US, in its traditional definition, has reached 220% of GDP, exceeding the previous maximum of 190% of GDP in 1929. The balance sheets of banks, corporations, and families reflect this fragility, and show the consequences of cumulative mistakes concerning financial decisions. Some of these mistakes were disguised by rescue operations by the government, as in the case of the bankruptcies of the American savings and loans corporations. Some of their effects have been postponed, as in the successive mistakes by American banks in extending loans to agriculture, the petroleum sector, the debt crisis governments, and real estate.

Last year was also a record year for personal bankruptcies and credit card delinquencies, as already mentioned.

Last but not least, there is the government. In the 1920s, America had a fiscal surplus and a current account surplus. Now it has twin deficits. In the 1920s, the US was the world's largest international creditor. Now it is the world's largest international debtor. In the 1920s, the high private sector debt was unaccompanied by a similar government debt. Today the American government debt is the highest in peacetime history.

Total debt in America approximates the value of all private real estate plus the value of American equities, when including unfunded public sector obligations. In other words, total debt is now equivalent to the value of the two most important components of wealth in America, excluding human capital — with an important difference. In a crash, the prices of both equities and real estate collapse (in the 1930s equities dropped 90% in value), while debt requires

painful liquidation.

When euphoria changes into pessimism and fear, this indebtedness, previously justified by optimism and confidence, will be perceived as dangerous. Creditors, initially apprehensive, later in panic, will try to recover their funds, eliminating credit renewals, thus forcing foreclosures and bankruptcies, and deepening the crisis. This is how it has been, and how it shall be.

When euphoria ends, debt liquidation begins. In 1933, Irving Fisher published his Debt-Deflation Theory of Depression in *Econometrica*. He explained how asset liquidation reduces the initial overindebtedness with massive bankruptcies, deepening the depression. At the end of the process, the country is in a shambles. But it's ready for recovery — a recovery without the burden of debt.

The liquidation of debt is the first step to recovery. This explains why the policy packages aimed at reactivating the Japanese economy after the crash of 1989 have failed. The total debt of corporations, households, and government in Japan still exceeds 300% of GDP today. Unless this debt is drastically reduced, no lasting recovery can take place.

By the way, did we not learn that central banks now know how to avoid major contractions? Is the Bank of Japan different? After growing 4.9% per year in 1988-90, real GDP per capita in Japan fell to 0.4% in 1991-94, with 1993 showing an actual reduction. The Bank of Japan lowered the interest rate under its control to implement what it defines as an expansionary monetary policy. The short-term real interest rate plummeted to 0% in 1997 from 5% in 1990. There is free credit in Japan, but Japan does not recover. Do central banks really know how to avoid or come out of depressions?

Fiscal policy has been expansionary. The surplus of 2.8% of GDP in 1989-91 turned into a 3.9% deficit in 1996. Government debt shot up 33% from 1990 to 1996 (from 69.1% to 92.4% of GDP). And Japan does not recover. Did not Keynes teach us that fiscal policy is the solution, the way out of a severe contraction?

Money growth (M2) in Japan has dropped from 12% per year in 1989 to negative in 1992 to less than 3% since. Are Japanese banks not lending? Maybe the figure of 300% of debt/GDP holds the answer.

Wall Street is today ending the last leg of the great bull market. The coming collapse will be worldwide, because most stock markets are synchronized with Wall Street. Even those markets in a different phase, such as the Japanese stock market, will experience a dramatic fall.

On the other hand, many stock markets are situated, as Wall Street is, at the end of the last phase of the bull market. This is true for stock markets in Germany, the UK, France, Switzerland, the Netherlands, Spain, Canada, Mexico, Brazil, South Korea, Philippines, Australia, India, and many others.

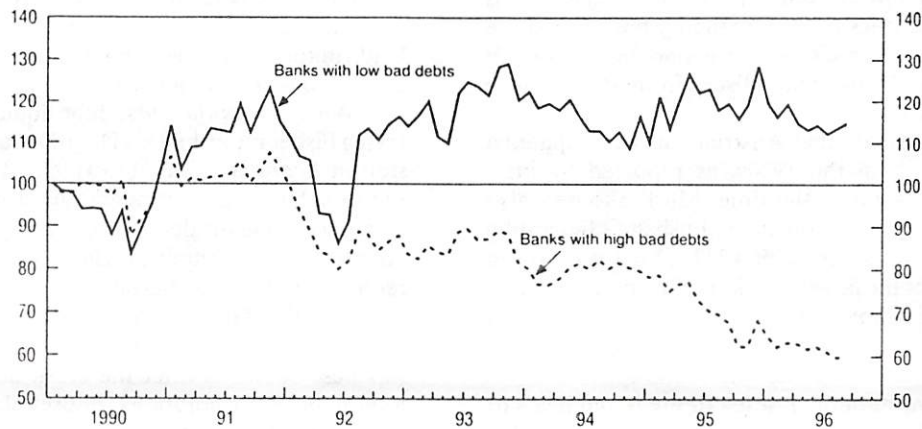
As these markets are synchronized in the same phase as New York's, they will soon begin to fall in a worldwide collapse of stock markets.

This collapse will anticipate, as the 1929 crash did, a severe contraction and depression in the world economy.

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Chart 1

SHARE PRICES OF BANKS¹
Weighted by loans



1. Only the major 21 banks are included in this analysis.
Source: Datastream and OECD.

CURRENCIES

Private investors finally like US\$

Recent trade figures underscore the impact that Japan's external sector has on its economic growth: Powered in large part by a 4.3% rise in export receipts in the October-December quarter from the previous quarter, GDP grew by 1% over the same period, implying an annual economic expansion of 3.9%. In fact, export growth has accounted for nearly half of Japan's economic expansion in the last two quarters.

While personal spending grew a brisk 1.2% in the quarter, compared with declines of 0.2% and 0.1% in the last two quarters, this was attributed to accelerated consumer purchases ahead of an increase in Japan's consumption tax to 5% from 3%, scheduled to take effect April 1. Past the Japanese new year (April 1), the external sector will take on even more importance.

In this light it is difficult to understand Minister of Finance Mitsuzuka's acknowledgment to Deputy US Treasury Secretary Lawrence Summers that Japan was committed to take measures as needed to ensure recovery led by strong domestic demand and to avoid a significant increase in its trade balance. Japan's current account surplus in 1996 represented a mere 1.4% of its GDP, well down on its 1993 ratio of 3%. The planned fiscal tightening for the year that begins April 1 will make it impossible for Japan to honor this commitment. Increasingly, the recovery will have to rely on a larger trade surplus, which can be achieved only by a weak yen (although not necessarily a continuing decline) — given the consumer's strong love affair with imported goods.

What can — and probably will — push the yen over the edge of fair valuation to one of deep undervaluation is a

disorderly and chaotic resolution to the ongoing banking crises. The probability of such an event taking place rises daily; the stock market value of the group of deadbeat banks continues to erode. It will not take long before a run bankrupts them or they are officially closed. And as yet there has been no official plan to handle the fallout.

The other sick currency, the deutschemark, has paradoxically received some support from Germany's economic woes, in particular its rising unemployment. The perverse logic runs as follows: Rising unemployment, now well above budgeted levels, make it impossible for Germany to meet its 3% deficit cap mandated by the Maastricht Treaty, as social contributions soar. Germany's weak fiscal position leaves it little room to exclude Italy, Spain, and Portugal from the first round on the excuse that these countries have not met their fiscal target. Therefore, these three countries may join the core players on Day 1 after all. But the German electorate in the fall of 1998 may not be prepared to see Germany enter a EMU with "soft" partners and may vote down the ruling coalition led by Kohl. This may in turn force a delay of EMU past January 1, 1999.

This possibility has reversed some of the massive and highly successful convergence positions built up over the last 12 to 15 months, putting upward pressure on the DM even *vis à vis* the US dollar. This strength, however, is viewed to be too indirect to alter significantly and more than temporarily the dollar/DM rate.

The lack of progress in passing the package of tax reform through Parliament, in particular the SPD-controlled

upper house, is dampening any enthusiasm that could arise from improved business sentiment numbers (no doubt heavily influenced by skyrocketing stock prices) and orders for machinery. The Germany of today, where public expenditures accounts for more than 50% of GDP and the total welfare budget is one third of the economy's domestic output, has little in common with post-war Germany and the *Wirtschaftswunder*.

State spending in 1966, the year Ludwig Erhard left office was less than 37% of GDP. Unemployment, despite a slowing economy that year, was a meager 0.7%, which compares rather favorably with today's 11.3%. Needless to say, Germany, as well as the rest of Europe, is in need of a drastic state overhaul. Fiddling with the deficit and debt levels to comply with EMU targets diverts attention from the real problems affecting Western Europe in general and Germany in particular. There has been no serious effort to reduce the welfare state. The real danger is that a super-bureaucratic EMU will entrench the various welfare policies, obstructing any serious attempts at reform.

Strong economic activity in the US, leading to higher interest rate differentials, continues to lend support to the dollar. Recent balance-of-payments statistics indicate that private capital flows have replaced foreign central banks in financing the growing US current account deficit — a positive development and the first sign, in many years, of independent strength. While the current account deficit rose to

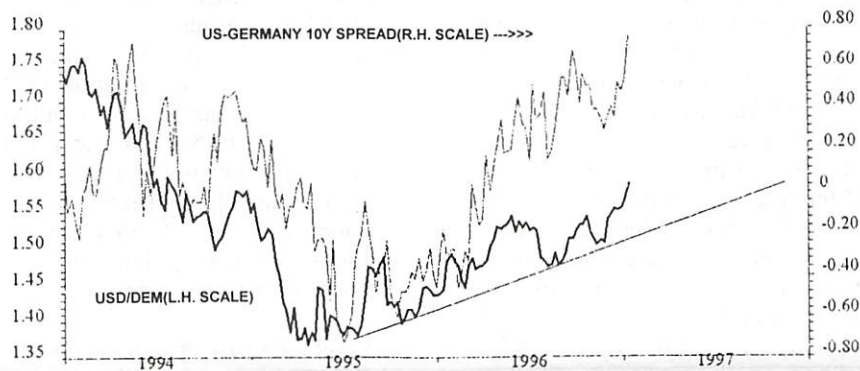
\$165.1 billion in 1996 from \$ 148.2 billion in 1995, private non-bank capital inflows rose last year to \$176.6 billion from \$60.9 billion a year earlier, leaving the combined balance in surplus of \$11.5 billion, the first such surplus since 1983.

In an earlier issue, we wondered why, with interest rate differentials *vis à vis* its main trading partners so pronounced, was the US dollar in such need of foreign central bank intervention (their accumulation of dollars had been financing US current account deficits for many years) to barely maintain its trade-weighted value for the past four years. We sniffed underlying weakness and posited that developing economic weakness in the US (or so it looked to us, at least last November) plus some minor improvement in Germany and Japan, would see the dollar collapse. We were wrong. The US economy has not weakened, Germany and Japan continue to writhe in misery, and private capital flows have finally moved to take advantage of favorable US returns, as evidenced by the latest balance-of-payments statistics.

The US dollar may be overbought, but the path of least resistance for now, say private investors, is upwards.

STRATEGY: Long dollar/yen positions continue to be quite in order. Risk is seen around 117, although the probability of this stop being touched is fairly low, at least until the banking crises comes to a resolution. Long New Zealand dollar/short yen positions should also be maintained.

Chart 2



Source: DATASTREAM

Chart 3 — Deutschemark



Chart 4 — Yen



ITALIAN LIRA

An interesting bear speculation

EMU fever over the past 15 months has led to an extraordinary convergence of interest rates between the weakest potential members (such as Italy, for example) and Germany, the bastion of Europe. The narrowing of spreads implied substantial DM inflows into Italy, causing the lira to appreciate more than 20% against the DM. Finally, on November 25, 1996, Italy returned to the Exchange Rate Mechanism (ERM) from which it had been forced to withdraw on September 17, 1992. The primary motivation of the Italian government for rejoining the ERM was the requirement that the lira remain within the target zone for at least two years before Italy can join the EMU. The lira is allowed to fluctuate within margins of 15% on both sides of the mid-point of the target zone, known as the central parity, which is Lit990/DM for the all-important bilateral band with Germany.

After setting a 31-month high of 966.45 on January 20, the lira has retraced through its central parity of 990 against the DM and now trades around 995-998.

In an effort to meet the Maastricht Treaty deficit criterion — a general government deficit below 3% of GDP by 1998 — fiscal policy has been tightened considerably in recent years. These efforts have been met with some success as the deficit narrowed to 6.8% in 1996 from 9.3% in 1994.

In the process, the government has had to resort to a number of supplemental or corrective budgets, with primary emphasis on tax increases rather than spending cuts. This was true of the 1996 budget, which explicitly proposed an almost 50/50 split between extra revenues and spending cuts at the state sector level but which in reality saw revenue increases rising to 80% of the total corrective action at the public sector level. This was also true of the more recent Lit62.5 trillion (\$37 billion) supplemental budget introduced at the end of last year (a proportion of at least two thirds tax increases and one third spending cuts). And finally, this will be true again with the mini-budget to be introduced soon for between Lit14 and Lit15 trillion, which supposedly will allow

the government to meet the deficit target on time.

It appears, however, that the government is chasing its own tail. These highly contractionary budgets, all the more so because they increase the already high level of taxation, have depressed economic activity to such an extent that Italy can be considered to be in a recession at this time. Industrial orders declined 5.9% on an annual basis last December after falling 10.3% in November, while industrial production declined 8% on an annual basis in December after falling 2.3% in November. In the final 3 months of last year, GDP fell 0.1% from the third quarter; on a year-on-year basis, GDP rose a meagre 0.5%. This performance compares with a forecast of 3% average real growth for the period 1996-98 assumed in the June 1995 budget plan and with Prime Minister Prodi's more recent forecast that the economy will grow 1.0% to 1.5% in 1997.

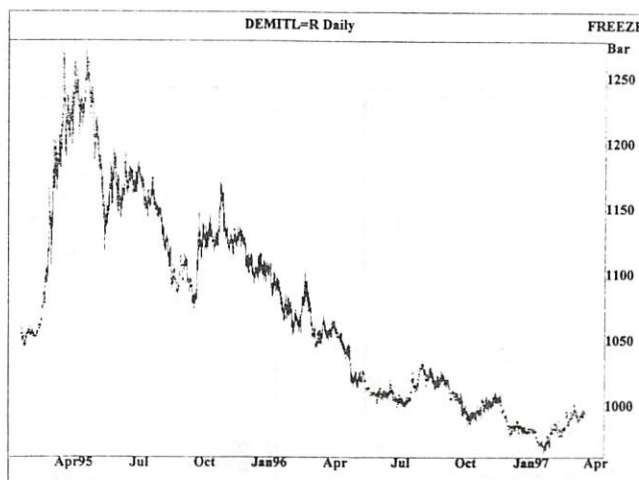
The economy had been heading south even before the late 1996 corrective budget. It is highly probable that the economy will not be able to support further tightening without stumbling into a depression and inviting social disorder (unemployment already exceeds 12%). As the popular saying goes, the operation was successful but the patient died.

A let-up in the fiscal effort, however, will almost certainly cause the exclusion of Italy from the first EMU round, if the EMU goes ahead. Furthermore, continued hints from German officials that Italy will be excluded from Round 1 may give enough ammunition to the more extreme leftist elements in the government coalition to force it to abandon the operation. Either way, the lira should collapse as convergence players unwind their positions.

Lira bears should keep their sights on the real side of the economy, looking for further signs of weakness and a softening of the government's political will with respect to carrying out the necessary fiscal correctives.

STRATEGY: A new recommendation: sell lira against dollars; the forward cost for one year is a mere 1.08%.

Chart 5 — DM/LIRA



POTPOURRI

Gold

Market rallied on massive short covering but downtrend is intact. Decline is resuming.

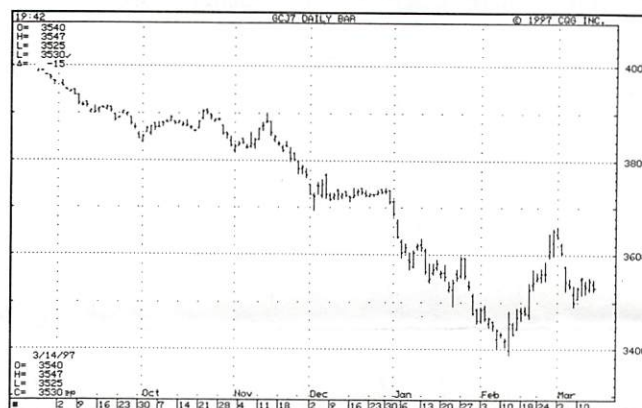
STRATEGY: Remain short as per March 7 Hotline Update, leaving stops at 367, basis April '97, good anytime.

S&P 500

We advised taking profits on March 13, via Hotline Flash Update in anticipation of an imminent increase in Fed funds. We believe that a new and better buying opportunity is at hand.

STRATEGY: Stay posted.

Chart 6 — Gold

**COPPER**

Room for speculation

The copper market has long been victimized by forces that propel prices to levels that the true commercial fundamentals would otherwise not have facilitated, also known as manipulation. Ultimately, though, markets are efficient, the smoke clears, and prices are once again guided by available supply provided by producers and demand by end users. If the copper market is now ready for this transition, then a proper accounting of the supply/demand situation would yield a trading opportunity.

As with many other commodities, we should perhaps begin referring to the supply/demand balance as the supply/China balance. The demand base for copper is shifting. Industrial production growth in much of the Western world has been declining, and with it growth in demand for industrial commodities. The Chinese, then, have the burden of picking up the slack if the enormous amount of new mine production is to be absorbed.

The evidence suggests that the Chinese are doing their part. The estimates for demand have been on the rise. The accuracy of any figures relating to production, imports, or stockpiles of Chinese copper leaves much to be desired. Nonetheless, it goes something like this: They can mine and refine about 300,000 tonnes. They can refine an additional 600,000 tonnes of imported ore. The balance has to be imported. It is believed that annual consumption will rise this year to 1.2 million tonnes, which represents an enormous rate of growth and over 10% of global consumption!

Recently it was thought that consumption was about 1 million tonnes. To illustrate the rate of growth, consider that with the above figures representing imports of close to a

million tonnes of copper in all forms, back in 1990 that figure stood at 100,000 tonnes! We have seen what effect China alone had on the corn market last year and soy products this year. What will they do to the price of copper?

For the supply side, we cross the South Pacific. As China is to copper demand, Chile is to supply. Over the past two decades, a torrent of international money has poured into Chile. The money was drawn not only to the friendly commercial environs but to exploit the vast natural resources of this country. Years of exploration and building of mines is now starting to bear fruit. With world production of close to 10 million tonnes, Chilean 1996 output of 3.1 million tonnes, or about 35%, makes it the swing factor in any discussion of the global copper scene. Chile's 1996 production of 3.1 million tonnes is up over 600,000 tonnes from 1995 output. And 1997 production is expected to rise an additional 200,000 tonnes plus. By 1998, Chile will be producing 3.85 million tonnes per annum. Since production began to rise in earnest back in 1989, the world's largest producer managed to more than double its output in just 10 years. So, while we are not trying to create any doubt at all about Chinese needs, the efficient market has responded to the call of demand and should be able to keep the world in balance.

Furthermore, a private think tank in China, to which we will give the benefit of the doubt in assuming their impartiality, reports that as a result of China's buying binge, it has stockpiles of as much as 250,000 tonnes. The same group says that the world balance is 100,000 tonnes in surplus. Combining warehouse stocks of both the London and New York markets also reveals that the copper hidden during the

Sumitomo era is slowly finding its way back to where we can see it. The all important backwardation of London cash to 3-month prices has collapsed from \$320 per tonne only 6 weeks ago to about \$50 now. Throw in a world average cost of production of about 65¢/pound vs. the current spot price of \$1.13 and one must wonder what would happen to the price of copper if all the external factors would disappear and the

market were dominated by old-fashioned fundamentals. The space between here and 65¢/pound leaves much room for speculation.

STRATEGY: Remain short as per Hotline Flash Update of March 12, leaving stops at 114.60, basis May '97, good anytime.
— Sholom Sanik

Chart 8

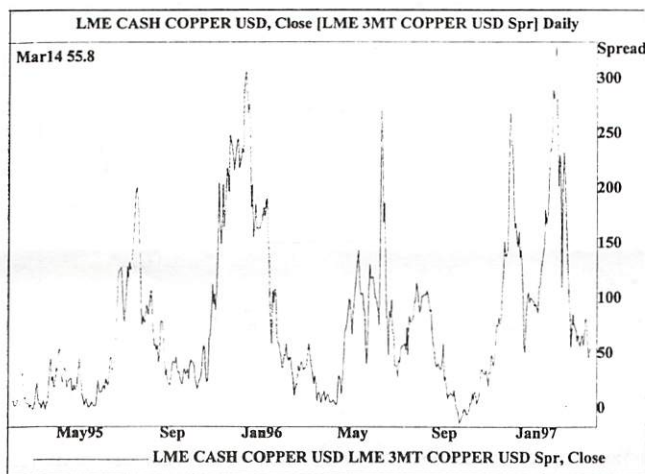
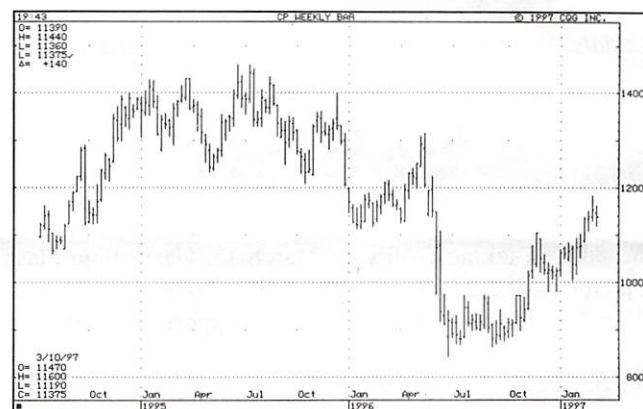


Chart 9 – Copper Weekly



SOFT COMMODITIES

Cocoa

The price of cocoa spent close to a year trading at \$1,350 per tonne, give-or-take a few ticks. Traders were torn between the mixed bag of fundamentals. On the one hand, there were the years of production/consumption deficits to consider; on the other hand, those deficits did not seem to be eating into the mountains of stocks. The new year seemed to usher in a sense of confidence amongst cocoa market participants as they finally took a stand, selling the market down and breaking the \$1,300 per tonne support barrier. It seemed that market had resolved itself and much lower prices could be seen on the horizon. This in turn, we argued, would allow consumers to eat into the overhang at favorable prices. An early hint of spring air brought the bear out of hibernation.

True to its notoriety as a market with particularly deceptive gyrations, after making new lows, it pieced together a rally in just two weeks' worth of trading sessions that covered the entire range of the past year. Analysts, including yours truly, were dumbfounded. After finally believing we understood the dynamics that drive this market, we were humbled. What happened?

The news that sparked the rally was a statement released by the Commodities Minister of the Ivory Coast, Alain Gauze. He said that the total crop, including the mid-crop, will be less than 1 million tonnes, which compares to private forecasters' predictions for a crop as large as 1.1 million tonnes. In itself this is not that bullish, because the official December government estimate was already 950,000 tonnes. The market didn't believe him back then, why should they trust the government's statement reflecting a vested interest in higher

prices now? The part of the statement that really spooked the market was his claim that the country had already sold 800,000 of the crop and that there is hardly anything left to sell. This would in fact be quite bullish, as there would not be any pressure on prices from harvest hedging. In addition, reports that Ghana sold two thirds of its crop forward only helped fuel the rally.

While this powerful thrust should be treated with respect, outside of the occasional planted bullish and bearish stories, little has changed on the fundamental front. As we asserted last month, the enormous amount of carryover stocks are up against the annual production/consumption deficits we have become accustomed to and which, quite frankly, are starting to get boring. With a reported carryover ratio of 40% or so of consumption, we take the position that at the very least this rally was overdone.

Monitoring of the contango in this market will ultimately provide insight to its direction. The contango has been harsh on dedicated bulls and remains so. The May/December spread improved, but is still at bear market levels. If these spreads would continue to narrow as the market consolidates, it might indeed signal that a dent was made in the stocks while prices were sliding in recent months.

STRATEGY: For the moment, we choose to be traders, albeit cautious ones. After having been stopped out we re-entered the market on the short side preferring to rely on the fundamentals rather than the wire story de jour. On Friday, March 14, we advised reinstating a short position in May cocoa, then trading at 1462. Place initial stops at 1475, close only.

Soy complex

The market spent January consolidating the \$7.50 per bushel range. Then came the February USDA situation report with the 20-year low in US carryover stocks of 140 million bushels. The market went into shock and tacked on a premium of \$1.25 a bushel over the period leading up to the March report. Part of the premium was anticipation of a further cut in ending stocks of 10 to 15 million bushels. On the morning of March 11, for a few hours after the USDA report was released, it seemed that the market had overshot itself by a wide margin. Ending stocks ended the months-long trend of dropping and came in unchanged from the previous month. Even more frightful was the fact that it was caused in part by a small downward revision in the annual export forecast of 5 million bushels to 900,000 bushels. Further trouble came from south of the equator. The old adage in the industry that "big crops get bigger" rang true as the USDA added another upward revision to the Brazilian crop of a half a million tonnes to 27 million tonnes.

Since the release of the report, though, the market has had time to digest the situation, and if we were to judge by prices, the initial bearish reaction has been rather subdued. The night before the report May soybeans settled at \$8.60 per bushel. As we go to press, the "bearish" report has sent prices "tumbling" to \$8.49 per bushel. Although the open interest is high in both the beans and the meal, both have managed to shed some of the excess with only a 10.5¢ drop in price. The open interest level in beans is still lower now than it was in the spring of last year when the market was trying to pierce the \$8.00 per bushel level, which, incidently, it never did with any longevity.

Back to South America, where the market perceived the Brazilian crop to be bearish for prices. A look at the entire South American scene, however, will show that this is not the case. First, a 27 million tonne crop for Brazil was hardly a

shock, as private forecasters had already spoken of such a crop. More importantly, an accounting of known supply and demand factors in South America will show that no new beans will be available. The USDA report also revised upwards Brazilian exports by one million tonnes to 4.2 million tonnes. Even after dropping Argentinean exports by half a million tonnes, no beans will be available to be added to global carryover stocks. Thus, while crops are getting bigger, they are accomplishing nothing more than keeping pace with growing demand.

Most recently the market has been guided by stories that US firms have begun buying cheaper Brazilian beans, which was given as the story behind the USDA's dropping of US export figures. Talk then emerged that the Brazilian government was set to reinstate an export tax that was designed to keep more beans at home to supply the profitable domestic crushing industry. The 3% tax would bring the price of Brazilian beans almost in line with their American counterparts.

The weekly export commitments show interest on the part of the Chinese and other foreign buyers remains healthy even at these prices. While most of the focus is on exports, the domestic side is no slouch. The USDA raised the domestic crush by 10 million bushels to 1,420 million bushels, which is a milestone, as it clearly vaults the crush into record territory above the previous record crush achieved in the 1994/95 season.

We concede that the market is overbought in light of the fact that the market had priced in a further reduction in ending-stocks. If the flow of exports and domestic consumption were to remain even stable, we feel the market will be able to work off the fluff with an orderly consolidation.

STRATEGY: *We continue to favor soymeal over soybeans and soybean oil. Remain firmly long, raising stops to 250, basis May '97, close only.*

Chart 10 — Soymeal



Corn

One year ago, as the 1996 planting campaigns were getting underway, corn was king. Booming exports had already eaten much of the beleaguered 7.3 billion bushel 1995 crop and prices were just crossing the \$4.00 barrier. Acreage that could go to either corn or beans would undoubtedly go to corn. Efficiently, market forces responded to rising prices, planting 79.5 million acres. The weather cooperated, and the third highest yield on record of 127.1 million bushels per acre gave us a 9.3 billion bushel crop. The high prices effectively curbed demand, and while the old crop prices eventually made it to \$5.50 per bushel, the new crop never even got a look at the other side of \$4.

The same is happening this year, only the opposite. Rising soybean prices assume that flexible acreage will go to soybeans. In mid-January the ratio of new crop soybean to corn prices was 2.62. This is well above the ratio at which the industry considers planting soybeans as far more profitable than planting corn. And here is what we see happening. During the period that the beans have been rallying, it is not surprising that old crop beans would outperform old crop corn, with the great export and crush numbers. However, during the same period, the new crop corn has been outperforming new crop beans, knowing full well that a ratio of 2.62 will lessen the likelihood of a bumper corn crop with swing acreage going to beans. Add in weather and planting uncertainties and a whole new concept is born. Old crop/new crop May/December corn spent the time since the market peaked in July erasing an increasingly unwarranted backwardation.

This past week, as the old crop months corrected the recent rally, December corn closed at a new recovery high.

It's clear to the casual observer that beans are the place to be, and for old crop we couldn't agree more. The more astute observer will notice that giving beans an outsized share of the available acreage puts new crop corn at risk. The market is now testing the resolve of the farmers as the new crop ratio has fallen to just below 2.5.

Foreign buyers have been showing their latent demand. Export commitments have been on a steady course that probably will render the USDA forecast of 1900 million bushels quite conservative. As we start consolidating around the historically high \$3.00 per bushel area, we will see if the buyer's interest is as keen at higher prices.

As far as fundamentals are concerned, very little has changed in the past few months. Until we have a clear picture of acreage the only thing to watch is the exports. The only change in the March 11 USDA report was a downward revision of the South African corn crop of 1 million tonnes to 8.5 million tonnes.

The one thing that is clear is that the near term is amply supplied by corn itself and substitute carbohydrate feed. The recent rally was on the back of the soybean market. If we were to buy corn our interest would lie in the new crop months.

STRATEGY: *We continue to be friendly to this market. However, we believe that soymeal holds more promise.*

— Sholom Sanik

**Chart 12 — Friedberg Capital Markets
Recommended current portfolio allocations**

1. 10 yr. Bunds, hedged (US\$)	15%	5. Canada FRN (US\$)	30%
2. US Treasury 6.25% '02 (US\$)	15%	6. The Learning Co. 5.5% cv (US\$)	5%
3. Petromet Resources cv 6.5% (CD\$)	5%	7. Sports & Rec. 4.25% cv (US\$)	5%
4. KIPT 9% cv (NZ\$)	10%	8. New Zealand Gov't 8% (NZ\$)	15%

Chart 11 – FOREIGN CURRENCY BONDS

DATE: March 14, 1997
 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 7 1/4% 13/10/99 RRSP eligible	107.15	108.00	3.90		Oct-13
World Bank 9% 13/11/00 RRSP eligible	116.90	-	-		Nov-13
Kingdom of Denmark 6 1/8% 15/04/98	102.10	-	-		Apr-15
Argentina 8% 5/10/98	103.10	103.95	5.24		Oct-05
Kgdm. of Spain (6 Mo. LIBOR-1/16) 29/6/02 (semi)	99.85	100.15	-	3.1875	Jun-30
CZECH REPUBLIC KORUNA BONDS					
General Electric Cap. Corp. 10.5% 23/10/98	98.75	-	-		Oct-23
Nordic Inves. Bk 10.625% 10/11/00	99.45	-	-		Nov-10
Intl. Fin. Corp 10% 30/4/98	98.10	-	-		Apr-30
SWISS FRANC DENOMINATED BONDS					
General Electric Cap. Corp. 4 3/4% 2/7/98	102.65	-	-		Jul-02
General Electric Cap. Corp. 4 1/2% 17/12/99	105.70	-	-		Dec-17
DANISH KRONE DENOMINATED BONDS					
Kgdm. of Denmark 9% 15/11/98	107.45	108.30	3.72		Nov-15
ECU DENOMINATED BONDS					
United Kingdom 9 1/8% 21/02/01	113.75	114.60	4.94		Feb-21
BRITISH POUND DENOMINATED BONDS					
European Invst. Bk. 7% 22/12/98	100.50	101.35	6.14		Dec-22
Kgdm. of Denmark FRN 28/8/98 3mo LIBOR-12.5b.p. (qly)	99.87	100.17	-	6.125	May-28
JAPANESE YEN DENOMINATED BONDS					
World Bank 4 1/2% 22/12/97 RRSP	102.90	103.75	-0.41		Dec-22
CANADIAN DOLLAR DENOMINATED BONDS					
Eksportfinans 7 3/4% 5/11/97	101.40	-	-		Nov-05
Ontario Province 10 5/8% 15/7/98 RRSP eligible	106.95	-	-		Jul-15
Petromet Resources 6.5% 31/3/04 (semi) CV @ \$9.50 p/sh	89.25	90.75	8.26		Mar-31
SOUTH AFRICAN RAND DENOMINATED BONDS					
ESCOM 11% 1/6/08 (semi)	78.75	79.60	14.78		Jun-01
AUSTRALIAN DOLLAR DENOMINATED BONDS					
Toronto Dominion Bk. Aust. 7.25% 26/2/99 RRSP eligible	100.65	101.50	6.39		Feb-26
NEW ZEALAND DOLLAR DENOMINATED BONDS					
World Bank 12.5% 25/7/97 (semi) RRSP eligible	101.30	-	-		Jul-25
World Bank 8.25% 30/4/99 RRSP eligible	101.35	102.20	7.08		Apr-30
New Zealand Gov't 10% 15/7/97 (semi)	100.20	-	-		Jul-15
New Zealand Gov't 8% 15/7/98 (semi)	100.35	101.20	7.03		Jul-15
Fletcher Challenge 10.75% 15/12/97 (semi)	100.50	-	-		Jun-15
Fletcher Challenge 10.15% 30/11/98 (semi)	100.60	101.45	9.19		May-30
Tranz Rail Ltd. 10% 15/10/99 (semi)	100.85	101.70	9.24		Apr-15
Trans Tasman 9% 27/6/99 (semi)	93.15	-	-		Jun-27
St. Luke 8.7% 1/4/99 (semi) CV @ 1.00 p/sh	147.75	-	-		Apr-01
Kiwi Income Prop. Trust 9% 30/9/03 (semi)	121.00	122.50	N.A.		-
ARGENTINEAN PESO DENOMINATED BONDS					
Bocon Pre 1: 1/4/2001	PAR VALUE 138.0949	121.40	123.15	IRR 9.47	May-01-97
U.S. DOLLAR DENOMINATED FIXED CONV. BONDS					
Atari Corp. 5 1/4% 29/4/02 CV@16.31 p/sh	59.25	-	-		Apr-29
Coeur D'Alene 6% 10/6/02 CV@ 26.00 p/sh	90.25	91.75	7.98		Jun-10
Sports & Recreation 4 1/4% (semi) 1/11/00 CV @ 25.5 p/sh	69.50	71.00	14.91		May-01
The Learning Co. 5 1/2% 1/11/00 CV @ \$53.00 p/sh	79.00	80.50	12.34		Nov-01
U.S. DOLLAR DENOMINATED FIXED RATE BONDS					
U.S. Treasury 6.25% (semi) 28/2/02	98.90	99.20	6.44		Aug-31
Queensland Tres. (Gold Bull) 2% 4/3/98	91.55	92.30	-		Mar-04
World Bank 7 1/8% 27/9/99 (semi) RRSP eligible	101.80	102.65	5.98		Sep-27
T.W.A. 12% 3/11/98 (semi)	97.90	98.75	-		N/A
U.S. DOLLAR DENOMINATED FLOATING RATE NOTES					
Kgdm. of Denmark 25/3/97 (Gold call, JY put), (semi)	93.00	94.50	-	9.50631	Mar-25
Canada Gov't 10/2/99 3 mo. LIBOR - 1/4 (qly), callable @ 100 RRSP eligible	99.71	100.01	-	5.25391	May-13
Bocon 1/4/01 (30 day LIBOR) starts paying May 1, '97	PAR: 132.2276 125.45	-	-		May-01-97
Argentina: Series L:FRB 31/3/05, 6 mo. LIBOR+13/16 (semi)	PAR: 98 88.95	90.45	9.16	6.625	Mar-27
Venezuela: DCB: 18/12/07, 6 mo. LIBOR+7/8 (semi)	85.85	86.70	10.21	6.50	Jun-20

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

HOTLINE UPDATE

Tuesday, February 25, 1997:

Good afternoon for Tuesday, February 25. There are no changes or new recommendations.

Flash Update, Thursday, February 27, 1997:

Good morning for Thursday, February 27, 10:00 am. This is a flash update. Liquidate long June T-bond positions at the market, presently trading at 110.15.

Friday, February 28, 1997:

Good afternoon for Friday, February 28. There are no changes or new recommendations. The following is a recap of this week's recommendations. On Thursday, February 27, via Flash Update, we advised to liquidate long June T-bonds at the market, then trading at 110.15.

Tuesday, March 4, 1997:

Good afternoon for Tuesday, March 4. There are no changes or new recommendations.

Flash Update, Wednesday, March 5, 1997:

Good afternoon for Wednesday, March 5, 5:30 pm. This is a Flash Update. All short positions in Japanese yen should be immediately replaced with short Swiss francs. This includes outright trades against US dollars and spread trades against British pounds and New Zealand dollars.

Friday, March 7, 1997:

Good afternoon for Friday, March 7. We have one new recommendation. Sell April gold at the market, placing initial stops at 367.00, good anytime. We repeat this week's recommendations.

- On Wednesday, March 5, via Flash Update, we advised that all short positions in Japanese yen should be immediately replaced with short Swiss francs. This includes outright trades against US dollars and spread trades against British pounds and New Zealand dollars.

Tuesday, March 11, 1997:

Good afternoon for Tuesday, March 11. There are no changes or new recommendations.

Flash Update, Wednesday, March 12, 1997:

Good morning for Wednesday, March 12, 11:00 am. This is a

Flash Update. Sell short May copper at the market, presently trading at 109.20, placing initial stops at 114.60, good anytime.

Flash Update, Thursday, March 13, 1997:

Good afternoon for Thursday, March 13, 2:40 pm. This is a Flash Update. We have two new recommendations. 1) Liquidate long March S&P positions at the market, presently trading at 795.00, cancelling the 770.00 stop. 2) All short positions in Swiss francs should be immediately replaced with short Japanese yen. This includes outright trades against US dollars and spread trades against British pounds and New Zealand dollars.

Friday, March 14, 1997:

Good afternoon for Friday, March 14. This is a complete summary since our last market letter dated February 23, of all liquidations of open positions and new recommendations that remain outstanding.

- On Thursday, February 27, via Flash Update, we advised to liquidate long June T-bonds at the market, then trading at 110.15.
- On Wednesday, March 5, via Flash Update, we advised that all short positions in Japanese yen should be immediately replaced with short Swiss francs. This included outright trades against US dollars and spread trades against British pounds and New Zealand dollars.
- On Friday, March 7, we recommended to sell April gold at the market, then trading at 350.80, placing initial stops at 367.00, good anytime.
- On Wednesday, March 12, via Flash Update, we advised to sell short May copper at the market, then trading at 109.20, placing initial stops at 114.60, good anytime.
- On Thursday, March 13, via Flash Update, we advised to liquidate long March S&P positions at the market, then trading at 795.00, cancelling the 770.00 stop, and we also advised to immediately replace all short positions in Swiss francs with a short position in Japanese yen. This includes outright trades against US dollars and spread trades against British pounds and New Zealand dollars.
- This morning, via Flash Update, we advised initiating a short position in May cocoa at the market, then trading at 1462.

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