

FRIEDBERG'S

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Seventy years later — the same dilemma

The money is talking, the remaining bears are capitulating, and the global stock market is rising unstopably to an intoxicating climax. So did Barry Riley aptly sign off a recent column in the *Financial Times* of London. A juggernaut and a foreboding sense of impending tragedy.

It was not much different 70 years ago. The decade of the '20s was "characterized by fairly rapid economic growth without major contractions. [It was] regarded at the time as a 'new era'..." With these words, Milton Friedman and Anna Jacobson Schwartz begin the sixth chapter of their monumental work *A Monetary History of the United States, 1857-1960*. The chapter was entitled "The High Tide of the Reserve System, 1921-1929."

The parallels are eerily reminiscent of our times. "As the decade wore on, the [Federal Reserve] System took — and perhaps, even more, was given — credit for the generally stable conditions that prevailed, and high hopes were placed in the potency of monetary policy as then administered." (Sound familiar?) There was growth and no inflation: In the 6 years from 1923 to 1929, real income grew at a 3.4% rate, wholesale prices fell at an annual rate of 0.9%, the price index implicit in real income grew at an annual rate of 0.1%. The stock of money rose at an annual pace of 4%.

The nirvana of the '90s has been slightly less luxuriant: Real income grew at a bit under 3%, wholesale prices climbed an annualized 1.2%, while the implicit price deflator did so by 2.1%. The broad money stock grew by only 2.25% per annum. The lack of close agreement between price and monetary behavior can be attributed to distortions arising in M2, because of the enormous inflows into mutual funds in the latter period and, possibly, an acceleration in velocity.

A good case can in fact be made that the present decade has witnessed a greater degree of monetary ease than the earlier period. In contrast to the '20s, where the yield curve was constantly negative from 1923 on (except for a few months around the beginning of 1924), the '90s witnessed a positive — and at times historically high — yield curve. Coming out of the 1923 mini-recession, the yield curve went from flat to a peak inversion (in 1929) of 225 basis points (bp). Coming out of the 1990 recession, the yield curve went from being flat to being positive to the tune of 435 bp at its peak at the end of 1992, remaining positive in the subsequent years and never falling below 75 bp.

Friedman and Schwartz contended that "The main features of the financial activity, which culminated in the great stock market boom, were the public floatation on a large scale of foreign securities for the first time in US history, and

a widening shift by domestic concerns from bank loans to public issue of bonds and stocks as a means of raising funds. One result of these developments was that they apparently led to a reduction in the average quality of credit outstanding, in the sense that the securities issued and the loans made in the late twenties experienced a larger frequency of default and foreclosure than those issued in the early twenties... the high prosperity of the twenties and the spreading belief in a new era understandably led to an increasingly optimistic evaluation of the prospects of repayment and hence to an increasing readiness to lend on a given project or collateral."

Just a few days ago, officials at Citibank said that the aggregate value of issues from emerging market *companies* (let alone the much greater totals for emerging sovereign debt) reached \$3.42 billion in the first half of 1997, up from \$2 billion in the same period of 1996 and out of a total of \$6 billion worth of issues for all foreign companies. Meanwhile, the dollar turnover of all ADRs, or foreign listed shares, rose by 20% in the first half to \$211.5 billion, reflecting the seemingly insatiable appetite of US investors for foreign securities.

The "widening shift by domestic concerns from bank loans to public issue of bonds and stocks" is a function of this very same public appetite for high nominal returns, causing credit spreads to collapse across a very wide spectrum of low credit quality securities (see Chart 1). The "increasing readiness to lend on any given project or collateral" has become an almost permanent feature of today's markets — from Credit

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Contributions by Albert D. Friedberg, and Sholom Sanik.

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Note: The July/August issue mails in early August.

Suisse First Boston's high-yield 95% loan to value advances against New York commercial real estate (for subsequent resale, of course, to the public) to multi-billion dollar bridge loans to Russian companies with no financial statements.

Nothing could mar the New Era effervescence of the Roaring Twenties except, of course, euphoria itself. This euphoria had been reflected in soaring securities prices and at least one group of men — the bankers of the Federal Reserve Board and the then-powerful and nearly independent Federal Reserve Bank of New York — expressed deep concern. "The difference," continues Friedman, "was about the desirability of 'qualitative' techniques of control designed to induce banks to discriminate against loans for speculative purposes... the view attributed to the Board was that direct pressure was a feasible means of restricting the availability of credit for speculative purposes without unduly restricting its availability for productive purposes, whereas rises in discount rates or open market sales sufficiently severe to curb speculation would be too severe for business in general. The Board's unwillingness to approve a rise in discount rates was partly, no doubt, a reaction to the severe criticism the System had suffered for the 1920-1921 deflation. The Board prevailed until August 1929, when it finally permitted the New York Bank to raise its discount rate. By then the New York Bank believed the time might have passed for such action."

While the Board asserted that "a member bank is not within its reasonable claims for rediscount facilities at its Federal reserve banks when it borrows either for the purpose of making speculative loans or for the purpose of maintaining speculative loans" — advocating in effect quantitative controls or, at best, moral suasion — the New York Fed argued that credit expansion [*i.e.*, *speculative loans — our note*] had grown too fast in comparison to business activity. We ought, however, not to be misled to believe that Harrison, the then Governor of the New York Fed, was a hard-money man, for in the same breath he expressed concern that interest rates were too high and represented a menace to the continued expansion! In fact, he really wanted lower rates and he was going to achieve this objective by "sharp, incisive action" involving a rise in the Discount Rate that would "quickly control the long continued expansion in the total volume of credit so that we might then adopt a System policy of easing rates."

There was no better way to rein in the raging animal spirits of speculation — the manifestations of "irrational exuberance," in the parlance of the mid-'90s — than by a quick and dramatic increase in the Discount Rate (the archaic predecessor, so to speak, of the Fed Funds rate). So did Harrison believe he could resolve the dilemma. Friedman commented that "it is by no means clear, of course, that this tactic would have worked, but it very likely would have hastened the end of the bull market." It is also no means clear that the Fed was excessively easy during this period.

As we pointed out earlier, from 1923 to 1929 the money stock rose at an annual rate of 4%. More importantly, high-powered money (better known as the monetary base — the only variable over which the Fed could have control) grew by a mere 1.1% rate over the entire period, rising at a 1.8% rate from 1923 to 1927 and then contracting over the subsequent 2 years. While admittedly not offsetting the rise of the deposit-currency and deposit-reserve ratios, the Fed sterilized gold inflows and for the most part behaved in a rather conserva-

tive fashion. This is in spite of the fact that the Fed was operating in the spirit of the thesis enunciated in the 1923 Tenth Annual Report: "that there is no simple test such as the reserve ratio, the exchange rate or a price-index number that can serve as an adequate guide for policy"; that policy 'is and must be a matter of judgement' based on the fullest possible range of evidence about changes in production, trade employment, prices and commodity stocks."

Seventy years on, the Fed has become a much more aggressive and sophisticated executioner of this very same spirit of indefiniteness; it now not only acts flexibly, but also "opportunistically" and "preemptively." It has allowed the monetary base to expand at a 6.8% annual rate in the face of an indeterminate but nonetheless real fall in the demand for money. Unlike the Fed of the '20s as we saw earlier, the present Fed has fostered — via excessively easy money — a steeply sloped yield curve.

It is worthwhile to note that the dispute between the Board and the New York Fed did not stop the System from tightening: (Upward) changes in the buying rate for bills, over which the New York Fed had more control, caused the System's holdings of bills to fall sufficiently during 1928 and the first half of 1929 to account for the contemporaneous decline in total Federal Reserve credit outstanding. In fact, the monetary base stayed roughly constant or declined slightly during those two years, while the stock of money was lower at the cyclical peak of August 1929 than in April 1928.

The New York Fed's continued insistence on raising the Discount Rate can be seen in retrospect as being more a matter of form than of substance. For all practical purposes — and in response to the stock market boom — the tightening had already begun in early 1928. This tightening failed to restrain the bull market but "did exert steady deflationary pressure on the economy. Wholesale prices...averaged a trifle lower during the three months centered on the cyclical peak of August 1929 than during the three months centered on the prior trough of November 1927...." In Friedman's opinion, there was "no doubt that the desire to curb the stock market boom was a major if not dominating factor in Reserve actions during 1928 and 1929."

Caught in the midst of a dilemma, the Fed followed "a policy which was too easy to break the speculative boom, yet too tight to promote healthy economic growth." He then continues, "In our view, the Board should not have made itself an "arbiter of security speculation or values" [*ed. note: the words used by the Board in its famous February 1929 statement*] and should have paid no direct attention to the stock market boom, any more than it did to the earlier Florida land boom...a vigorous restrictive policy in early 1928 might have well broken the stock market boom without its having to be kept in effect long enough to constitute a serious drag on business in general."

Friedman's conclusions are based on his belief that tight money caused and aggravated the Great Depression. This thesis has never been proven. Austrian economists have long argued that easy money stimulated a malinvestment boom that had to be liquidated in the subsequent downturn and that the severity of the depression was directly proportional to the investment excesses of the boom.

One can sympathize with his view that the Fed should have paid no more attention to the stock market boom than

to the earlier Florida land boom, since after all, the Fed was only moderately responsible for the boom. Still, one wonders how many more participants would have been caught in the speculative whirlpool had the Fed not tightened as dramatically as it did, and how much worse would the impact on confidence have been (or the number of malinvestments, in the Austrian thesis) as a result of the inevitable crash.

Be that as it may, our own conclusions — based on the few monetary indicators that we reviewed — are that the Fed of the '90s bears more culpability than the Fed of the '20s. *Staying the course is no option.*

In 1997 the economy is growing at a satisfactory pace, inflation is moderate, yet the stock market is gripped by one of the greatest financial manias in history. By following an excessively easy money policy, Greenspan's Fed has stoked the fires of speculation more than any other group of central bankers in American history.

Although we lack precise numbers, it is a given that the amount of public participation in this Mother of All Bull Markets easily surpasses the one attained in the '20s. In mutual funds alone, the public has invested (including gains)

over \$3.5 trillion, three quarters of it in only the past 6 years, far more than it owns in bank savings and small and large time deposits.

Consumption levels are being sustained by the steady decline in the savings rate caused by the mindless increase in consumer credit and comforted by the growing level of household "net worth," the much-talked about wealth effect (see Chart 2). A serious stock market decline and a tightening of consumer credit could wreak havoc on the economy.

Seventy years on, the Fed faces a frighteningly similar dilemma: to put an end to the boom in the securities markets by sharply raising interest rates, and risk a serious economic contraction, or to follow Milton Friedman's advice (would he proffer the same advice today?) to stay the course with regard to monetary policy and allow speculation to burn itself out, hoping for a miraculous economic soft landing in the face of an horrendous eventual crash. The July 2 Fed meeting may give us the first clue to the likely resolution of this dilemma.

Those who cannot remember the past, it has been said, are condemned to repeat it.

Chart 1

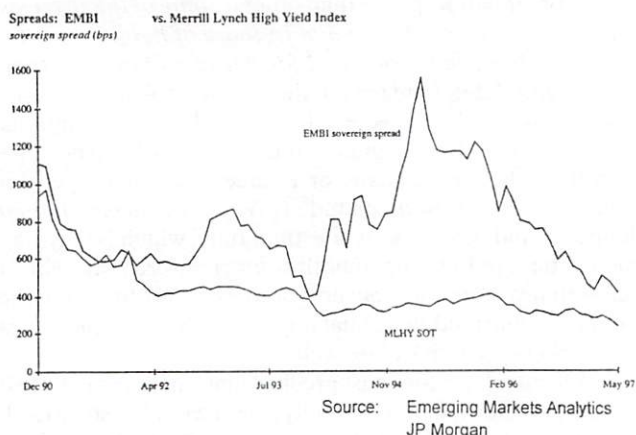
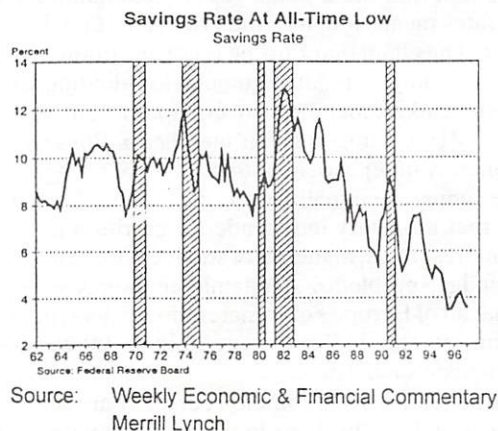


Chart 2



THE INTERNATIONAL ECONOMY

A soft euro?

By Alan Reynolds

The Socialist victory in France, and the row between the German government and the Bundesbank about revaluing gold reserves, has led to renewed speculation that plans for a European Central Bank and common currency will be delayed, scrapped, or wind up as a "soft" currency. But convergence of bond yields among likely EMU countries suggests that the current Exchange Rate Mechanism (ERM) will evolve into a monetary union, most likely on schedule. Surveys of well-informed experts agree.

The Bundesbank is not exactly a disinterested observer of its own demise, and unelected central bankers only imagine they're in charge. The French left presided over the *franc fort* from 1983-93, and pushed hard for EMU. Prime Minister Jospin hopes to see Italy and Spain included, but that isn't his

call. He also has legitimate objections to the recent "stability pact" (fifty U.S. states share a common currency without meddling in each other's tax policies or bond issues). France won't block EMU.

If EMU is seen as a solution to the poor economic performance of Europe, it will prove a major disappointment, like the earlier euphoria about "Europe 1992." EMU is a distraction from the structural reforms that Europe needs to undo the crippling disincentives of oppressive tax, transfer, and regulatory schemes. As Rudi Dornbusch remarked at a recent Manhattan Institute dinner, "The answer for Europe is supply-side economics." That is a topic for another day. For now, we need to take a first look at what is likely to happen between now and January 1, 1999, when EMU ex-

change rates are to be irrevocably fixed.

In many respects, this is not as new as it seems. Exchange rates between Germany, Austria, Belgium, the Netherlands, and Luxembourg have been fixed for many years, with the French franc also remaining tightly fixed for more than a decade. Adding Ireland and Finland would not matter much. So it is difficult to see why the idea of fixing exchange rates in a more formal manner now generates so much enthusiasm or fear. A monetary union is a more binding and credible way of doing what these countries are doing already. If the mark and franc are virtually two words for the same thing, using one word to describe them is largely a symbolic gesture.

Spain and Portugal are close to meeting the Maastricht rules, even the relatively frivolous demand that government borrowing be limited to 3% of GDP this year. It is somewhat difficult to imagine the inclusion of Spain and/or Portugal without Italy. Italy is widely expected to be rejected because interest rates are too high, but interest rates are too high because Italy is likely to be rejected.¹ Britain will wait and see, although the new government's move toward an independent central bank makes later U.K. membership a possibility. There will probably be eight to ten initial members, with Italy put on hold for one reason or another.

The fact that these countries are maintaining fixed exchange rates means much of the criticism of EMU is beside the point. The claim that Europe is not an "optimal currency area," for example, is an argument for floating exchange rates. But the likely members are not floating anyway, with or without EMU. Complaints that member nations would lose the "monetary independence" to devalue or engage in monetary fine tuning are equally irrelevant. These countries have learned that monetary independence carries a high cost — higher interest rates, higher debt service costs, and therefore bigger budget problems. Academic economists are free to argue that all of Europe's currencies should float, or even that Massachusetts should float its own dollar.² But we have elections to decide such issues.

The advantages of a common currency are similar to the advantages of doing business in the same language: It lowers the cost of information and transactions. EMU may also add depth and liquidity to capital markets. Potential troubles with EMU arise mainly in the transition to the new system. The biggest transitional risk — a deliberate or speculative devaluation of any EMU currency — may soon be minimized. Exchange rates might be set before the end of this year.³ Once a European Central Bank is in place, by 2002, that allows *unlimited* intervention in support of fixed exchange rates, and defection would require reintroducing national money.

Assuming the EMU flies, will the euro be a soft currency? The answer partly depends on how we define "soft." Does the word "soft" mean the euro's value will be automatically diluted by the (possible) inclusion of countries like Italy that suffer from chronic budget deficits and debts? Does it mean the process of monetary policy in the EMU will be more subject to political pressure than the current Bundesbank or Federal Reserve? Does "soft" mean the euro can be expected to depreciate more often than not against the U.S. dollar, British pound or Swiss franc? Does it mean the euro is likely to fall in value relative to gold? Does it mean that price indexes are more likely to rise at a faster clip than otherwise? Does it mean that the EMU members will have higher bond

yields, relative to past performance or to non-EMU countries? A soft currency might imply all of these things, but not necessarily. The various criteria tell different tales.

Soft on Big Spenders?

A common anxiety is that including previously weak currencies into the group must somehow "dilute" the purchasing power of the euro. Italy is everyone's favorite scapegoat in this respect, even though Italy is unlikely to be a founding member. The "dilution" metaphor does not get us very far. Italy's membership in the EMS did not make other DM-bloc currencies visibly less reliable. Why should the EMU be any different? Two reasons have been offered. One is that being part of EMU is said to create a "moral hazard," because countries can supposedly engage in runaway deficit spending without concern about the negative impact on their bond yields. Another is that countries like Italy and France are thought to be both willing and able to pressure the European Central Bank into pursuing more inflationary policies, or into bailing them out.

The first concern — like the Maastricht targets for budget deficits and debts — reflects a fiscal theory of money. Yet neither deficits nor debts explain why some currencies have been more inflation-prone than others. *Some of the strongest currencies in the world — notably, those of Belgium and the Netherlands — have coexisted for decades with huge fiscal deficits and debts.* One reason their debts look large relative to GDP is that they have not inflated GDP. Italy's national debt is no larger than Belgium's, relative to GDP, and no larger than the debts of Germany or France if unfunded pension liabilities were properly included. When it comes to *foreign* debts, Ireland now looks worse than Italy, which is why Italy has a better credit rating. If both countries were borrowing in euros that distinction between domestic and foreign debts would become muddled. That might confuse rating agencies, but markets price risk quite well.

A former EC economist predicts that "making the British, French and Germans pay for Italy's debt would destroy EMU from the outset."⁴ But *Italian bonds denominated in euros would still be the debts of Italy, just as Mexican bonds denominated in dollars are debts of Mexico and Turkish bonds denominated in Deutschmarks are debts of Turkey.*

Another economist worries that if weaker countries "simply spend more and run up large deficits," then the European Central Bank "could choose to either print money and validate their higher spending or to push up all interest rates and, thereby, refuse to validate their spending."⁵ This presumes that a budget deficit in one country must push up interest rates for all members, unless the central bank prints enough money to hold interest rates down. The reasoning is dubious. If

¹ By shrinking devaluation risk, EMU could cut Italy's budget deficit by 1.5% of GDP. "From here to EMU." *The Economist*, Aug. 5, 1995.

² Martin Feldstein, "The Case Against EMU," *The Economist*, June 13, 1992. Feldstein cites Massachusetts to suggest that "slowing the growth of wages is a painful process," best avoided by devaluation.

³ Neil Buckley, "Rates for Emu could be set this year," *Financial Times*, May 15, 1997.

⁴ Bernard Connolly of AIG Trading, in a letter to the *Financial Times*, Nov. 18, 1996.

⁵ John H. Makin, *Economic Outlook*, August 1996, American Enterprise Institute (AEI).

interest rates really depended on budget deficits, then Japan would have the highest interest rates of any major nation. If printing money kept interest rates down, then Turkey would have Europe's lowest interest rates.

Although membership in a monetary union should reduce the exchange rate risk premium in bond yields of countries like Italy, it would not eliminate default risk. If Italy were in EMU, then Italian debt instruments would carry a higher premium for credit risk than comparable German securities, just as Belgian bonds currently command higher yields.

Soft on Politicians?

Suppose politicians in certain EMU countries have a taste for "easy money." What could they do about it? "The concern," notes Allan Meltzer, "is that, in some future fiscal crisis, a country will bargain for a bailout by the central bank in exchange for an increase in domestic taxation or a cut in government spending."⁶ But the new central bank would have no legal authority to bail out governments. As Rudi Dornbusch points out, "The provisions for the European central bank assure that the institution is independent, cannot solicit or accept guidance, and cannot finance governments."⁷ The European Union already subsidizes poorer members in the south. But there is little reason to suppose that membership in EMU would either impose more hardship on such countries (their interest rates should fall), or make the richer countries willing to send them more cash.

Soft on Exchange Rates?

If the strength of the EMU is to be judged by its exchange rate with the dollar, the new plan is no different from the old. Exchange rate policy between the euro, dollar and yen is to be decided by finance ministers, at G-7 meetings and the like. *The external value of a euro would be exactly equal to one ECU.*

Figure 1 shows the dollar exchange rates of the two biggest EMU players, and one strong currency outside of EMU—the Swiss franc. The leading EMU currencies have not shown a great propensity to debase their currencies against

the dollar over the past decade. On the contrary, these currencies gained against the dollar from 1986 to 1995. The relative recovery of the dollar (and British pound) over the past two years may, in part, reflect anxieties about a soft EMU. If we take a longer view, however, U.S. and U.K. are in a poor position to be calling other currencies "soft." Switzerland, on the other hand, makes a better benchmark to gauge sentiment about the euro. *To the extent that world investors become concerned about a soft euro, the French franc and or German mark could be expected to depreciate against the Swiss franc, and the already wide spread between their bond yields and those on Swiss bonds could be expected to widen.* The French election *did* inspire some speculation against French and German currencies although their bond markets remained reasonably calm. Switzerland's role as a potential haven against EMU (or dollar) instability also helps explain why the Swiss *stock* market has been so strong this year, up about 20% in dollars. *The Wall Street Journal*, June 5, reports that the Swiss National Bank is trying to talk the Swiss franc down, with limited success. The Swiss franc has such an awesome reputation that lower interest rates just create capital gains that may attract more capital.

Figure 2 shows that bond yields have been consistently lower in Switzerland than in Germany, despite the fact that both currencies have been equally "hard" as measured by exchange rates. The gap is much more than a premium for Germany's post-1993 withholding tax on interest, since Switzerland has a similar tax. Switzerland's currency is considered more secure because of trust — namely, confidence in its uniquely impressive gold backing.

⁶ Allan Meltzer, "The Problem of Monetary Union," *On the Issues*, May 1996, AEI.

⁷ Rudi Dornbusch, "Fiscal Aspects of Monetary Integration," *American Economic Review*, May 1997.

Figure 1

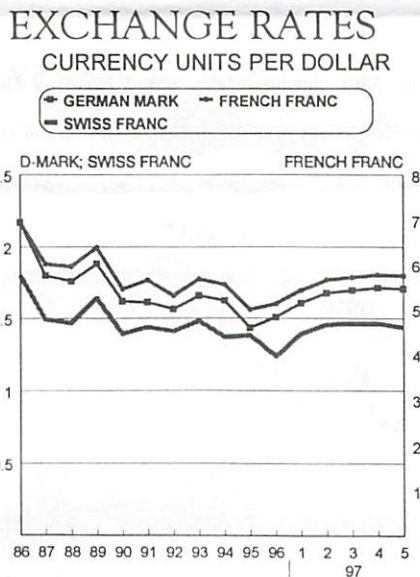
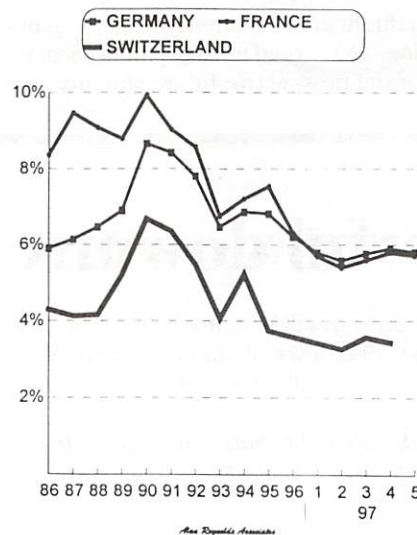


Figure 2

BOND YIELDS
10-YEAR GOVERNMENTS



Until EMU, our only previous experience with new currencies gaining rapid acceptance has been limited to countries that either tied their currency to one of the world's best, or had the capacity to redeem the new currency for silver or gold, or both. Estonia's new kroon, for example, is mostly backed by gold reserves (like the Swiss franc) and fixed to the German mark.

The European Central Bank (ECB), by contrast, will maintain no gold reserves other than those held by member nations. It would be set up with reserves worth 50 billion ECU, drawn from members. Moreover, EMU countries seem to think that shifting responsibilities to a European central bank is an opportunity to liquidate gold reserves.

The core EMU members currently maintain foreign currency reserves of about \$200 billion, with some \$40 billion in Deutschemark and \$10 billion in French francs. But countries of EMU will no longer need to stockpile each other's currencies to pay for imports, or as a war chest for foreign exchange intervention. For balance of payments purposes, trade within the EMU bloc becomes internalized. "So while the euro area's reserves would fall 25 percent, its imports would fall 40 percent."⁸ International reserves are already down in all of the core EMU countries — even those with big current account surpluses. For the year ending in March, Dutch reserves fell by \$2.9 billion (9.3%).

With much less need for international reserves among EMU members, current gold reserves are also likely to appear excessive. Germany's contentious plan to revalue its gold reserves (a prelude to gold sales?) is not the first EMU scare to rattle the world gold market. Last year, *The Financial Times* (Nov. 18) reported "fears that some European countries will make substantial sales from their official gold reserves in order to meet the criteria for monetary union." Indeed, Belgium sold a large portion of its gold reserves, raising \$2.4 billion-equivalent to around 1 percent of GDP. The Netherlands also sold substantial amounts of gold. *The Wall Street Journal* (Nov. 22) noted that even Switzerland "began considering a proposal to abolish its central bank's gold requirement."

The leading contenders for EMU hold combined reserves of more than 240 million ounces of gold, worth about \$82 billion. Italy, Spain and Portugal have another 98 million ounces. The EMU-related chance that there might be significant sales from this hoard may already be artificially depressing the gold price. That would make it paradoxical to use gold as a measure of the prospective future stability of the euro.

GOLD

Powerful downtrend

The powerful downtrend remains in force as the market approaches the 1993 lows of approximately \$330/oz. We believe that these lows will be broken.

STRATEGY: Remain short; lower stops to \$343, basis August '97 close only.

Prices of platinum and palladium have been rising briskly of late, in dollars.

Robert Samuelson, in the *Washington Post* (Jan. 8), quotes Fred Bergsten predicting "the Euro is going to be a weak currency." Yet Bergsten also predicts that Japan and other nations will hold a much larger share of their reserves in euros.⁹ That would make the euro rise and dollar fall. If the euro is a weak currency, it will not displace dollar reserves. If the euro is a major reserve currency, it will not be weak.

Soft on Inflation?

Although German and Dutch central bankers give lip service to measures of the money supply, they actually adjust interest rates to fine-tune the real economy. When dealing with a brand new currency, even the pretense of targeting the money supply could not possibly inspire any confidence.¹⁰ The ECB is most likely to be held accountable for meeting *explicit inflation targets*, using the EU's new harmonized consumer price index (which excludes housing, education and health care). Experience with inflation targets is short, beginning with New Zealand in 1989. But the *transparency* of the scheme looks more promising than the more familiar system of operating by pure discretionary whim. *Assuming the ECB is given a mandate to hold regional inflation below 2 percent, for example, many of the other "soft" euro concerns would be greatly alleviated.* Such a mandate would not be consistent with the euro being chronically weak against the dollar, or with the central bank monetizing Italian bonds.

The European Central Bank will not get two chances to make a first impression. This could give the euro a deflationary bias in the early years. There is much that could go wrong with EMU, from politics to technical glitches. Yet it is much too soon to assume the worst, as so many agitated articles in the English language tend to do. So long as the bond yields of Germany and France remain well below those of the U.S. and U.K., the market's judgement is that the euro is unlikely to be quite as soft as the dollar or pound, nor as hard as the Swiss franc. As usual, the market is probably right.

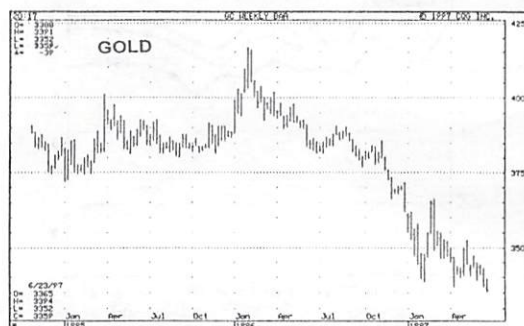
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⁸ Robert Chote. "Central banks may decide fate of euro." *Financial Times*, Apr. 18, 1997.

⁹ Robert Chote. "Euro may unseat the dollar." *Financial Times*, Mar. 24, 1997.

¹⁰ Thomas Mayer. "The way to price stability." *Financial Times*, Sep. 6, 1996.

Chart 3



ITALY**Ciao, for now**

Economic activity under the weight of new taxes and an overbearing state apparatus continues to crackle — in slow motion. Yet the EMU bandwagon seems almost unstoppable, and Italy's participation in round one seems almost assured, especially in view of the poor fiscal performances of Germany and France.

STRATEGY: Cover short lira positions. Let's wait for another day.

CURRENCIES**NSF Czech**

Recent figures (including the Tankan) do not as yet provide enough evidence that the Japanese economy is on a solid footing, although clearly the recovery has not stalled. Banking issues have continued to recover, even outperforming the industrial index, but as yet there is no evidence of a comprehensive banking resolution.

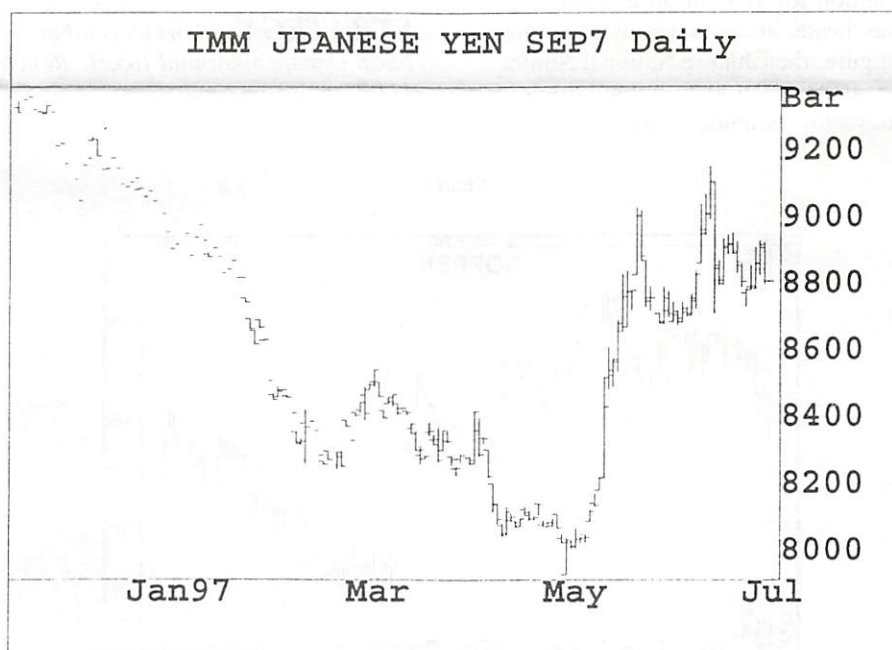
One of the first casualties of the end-of-the-global-boom theme is the fall of the Czech crown. (See "Fraying at the edges" in our April issue.) The timely abandonment of the peg vis à vis a 65% DM/35% US\$ basket, and the skillful manipulation of interest rates by the monetary authorities bought some time for the ruling coalition to win a vote of confidence and allow the passage of a number of fiscal measures that will attempt to balance the budget by the end of this

fiscal year. In the meantime, the currency strengthened from -10.5% from the central rate to slightly more than -6%. In view of the gaping 7%-8% of GDP current account deficit, the fiscal moves are courageous but not sufficient.

At the same time, interest rates remain too high for the ailing economy and the loss-ridden commercial banks. As the economy continues to contract, we expect new pressure to develop on the Czech crown, which by year-end should be trading at more than 15% below the former central rate.

STRATEGY: Short the crown, taking advantage of the recent fall in short-term interest rates. Stand aside on the major European currencies and the yen.

Chart 4



COPPER

Going with the flow

The news in the copper market has been slightly bullish. The two main attractions have been the weather in Chile and Chinese demand. Severe winter weather in Chile was hampering production. While it is certainly not a serious problem, it is the kind of issue that adds to the bullish sentiment. The more structural story that has been featured in the media is that the Chinese traditionally do their buying in the second half of the year. This explains their absence from the market thus far this year and should install a fear premium in the price.

Further evidence of tightness is a depletion of warehouse stocks in London by almost half of the peak level this year of 220,000 tonnes. The stocks have stabilized at about 125,000 tonnes but remain at their lowest level in years. The cash-to-3-months spread in London, the old reliable indicator of the future direction of copper prices, was solid as a rock and climbing, and sits at about \$110 per tonne, compared with a spread that was as low as \$40 per tonne only weeks ago.

Yet, the market was rocked this week by a dramatic drop that spoiled a lovely uptrend on the charts. The events of this past week, whether the slide in prices spells the end of the bull run or not, highlight the truth. The price of copper is in the grip of a few important players, and they have maintained artificial prices. As soon as they choose to step aside, the market has little support from elsewhere.

Probably the most important news in the copper market to emerge in some time was very bullish. Earlier this month Bankers Trust released a report suggesting that Chinese copper consumption has been dramatically understated. The investment bank was first alerted when the Chinese State Statistical Bureau published a report 7 months ago putting Chinese copper consumption for 1995 at an amazing 1.58 million tonnes. This was heads above not only the other Chinese source for this figure, the Chinese National Nonferrous Metals Corporation, at 980,000 tonnes, but hundreds of thousands of tonnes above the estimate of virtually every

Western analyst, as well. The Bankers Trust report went on to soften the figure considerably to 1.3 million tonnes. Using known production patterns, this would turn the global copper scene into a deficit market. This report provided a backdrop for the rally that preceded last week's drop. The fact that the market lost all of the rally attests to the wild array of opinions that exist in the copper market and the skepticism such a report is greeted with.

Another reason to temper excessive optimism regarding Chinese copper consumption in the immediate future is the state of the economy. While strong buying might continue for food commodities, a weakening economy will hurt consumption of industrial commodities as heavy industrial growth remains flat.

Capacity of utilization runs at about 50%, significantly below the average of Western economies. In addition, every economy is at the mercy of its banking system and China's could be in trouble. Before reform came to China, the banks had a monopoly on savings. Now investment capital is going elsewhere, and as the state-owned banks make the adjustment, the reduced availability of capital for areas that would eventually affect purchases of industrial commodities will be felt.

All the while, Chilean copper keeps coming, making the likelihood of deficits small. More importantly, while the supply side numbers are so very erratic, the production data are steady and not contested.

We consider copper to be one of the most overpriced of major commodities. We have steered clear of trying to pick a top in this market. Rather, we waited for the market to show us weakness, and we will now go with the flow.

STRATEGY: Short December '97 copper as per June 25 Flash Update at around 105.50. Remain short. Place stops at 111.75, good anytime.

— Sholom Sanik

Chart 5



SOFT COMMODITIES**Cocoa**

A very successful veteran trader close to our group once said, "I feel no shame for changing my mind by reversing direction in the market, regardless of how strong a case I had been making for the earlier position. Call me what you will, but I will feel shame only for not making money in the markets by allowing the vanity of pride to stand in my way."

After being short the cocoa market and having invoked the above disclaimer, we feel the air is clear. We can now discuss the anatomy of the failure of the bearish argument and, of greater significance, look to the bull market in blossom.

We had been speculating all along on the side of the supply/demand fundamentals at hand. Carryover stocks are huge at 40% of consumption. Upward revisions have been made by all major analysts to the production/consumption balance for 1996-97, leaving a smaller deficit. However, now that the market has exploded through the ceiling of multi-year highs, the market is betting that the alleged hoarders will continue to hold their prize. Sentiment has shifted and traders are focusing on the bullish fundamentals we referred to last month.

In addition, the lowering of the production/consumption deficits might have been a tad premature, as the Ivory Coast midcrop will not meet expectations and could be as low as 100,000 tonnes. Ironically, there has been some good precipitation, which is good for the 1997-98 early settings, but is hampering the drying of this season's mid-crop, accounting, in part, for its poor showing.

Traders have also focused on the El Niño weather pattern, which shows up every few years and plays havoc with regular weather patterns, causing dryness in areas that need rain. Particularly sensitive to this problem are African and Asian crops. Judith Ganes, Senior Softs Analyst at Merrill Lynch, tells us that in some El Niño years, as much as 13% of global crops were lost. A rough projection of a 13% loss of the 1997-98 crop would see global output drop by 350,000 tonnes. If grindings were to grow by the 3% growth rate expected to 2.88 million tonnes and production dropped to 2.35 million tonnes, ouch! We would experience a 530,000 drawdown in stocks, putting stocks-to-consumption at a ratio of 31%, right in bull market territory.

It is now commonly accepted that El Niño will affect 1997-98 output to some extent. Although it is very early in the growing season, the threat does exist, and the market is establishing an El Niño premium.

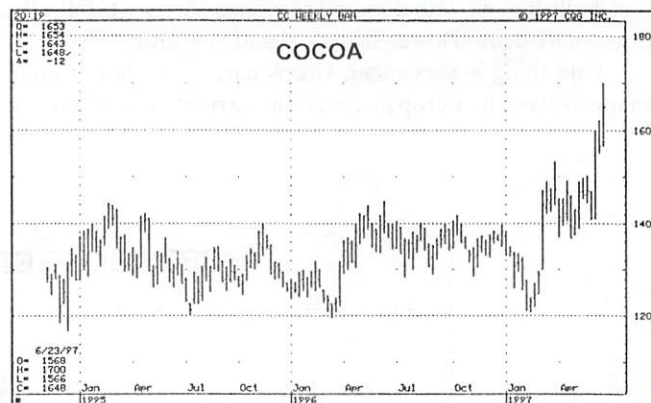
Another issue is the open interest, which is huge. The combined open interest of London and New York represents about 2.75 million tonnes of cocoa beans, which is about two thirds of available supply. There are various ways of interpreting this data. Whether one reads it as a speculative bubble or otherwise, one thing is certain, the size supports

strongly the rumor that the Ivory Coast has sold two thirds of its 1997-98 crop forward. This means the crop is "sold out," which eliminates a major source of price stability, harvest hedging.

The ultimate gauge of what's going, as always, is the most basic of statistics, the price. As long as the market was contained below the multi-year highs, we maintained that the stockpile was not being reduced. The breakout may well be an indication that the real size of the burdensome stockpile, its quality and mobility are in question.

STRATEGY: Remain long September '97 cocoa, as per Flash Update of June 19. Maintain stops at 1570, close only.

Chart 6

**Soy Complex**

The soy market is still being fed a steady diet of mostly bullish news. Yet, the market has stalled and trades between \$8.00 and \$9.00 a bushel. The scenario we see unfolding is one in which demand remains robust but prices remain stable. After all, these prices, even for the new crop, are high by historical standards. It is no great secret that demand has been growing, and thus prices may already be carrying the appropriate premiums. The question is, Can the new US crop feed the world? This is unknown and we believe, until further notice, that the market will hover within, say, 5% of current values.

One indication that a rationing process of some degree has begun lies in the USDA crop report released on June 12. Traders and farmers had become accustomed to the monthly drop in ending stocks, but in the June report the USDA actually raised its estimate for the amount of stocks to be left at the end of the 1996-97 season by 5 million bushels to 130 million bushels. It is not really that much of a change. The point is that we knew long ago that ending stocks would be

about this level. With the first upward movement in this figure, which was thought to be over 200 million bushels only months ago, the amount of ending stocks may be finding the level that is commensurate with current price levels.

Nevertheless, there is much life left in this market as global demand continues to grow. The market's ability to break out of the current ranges will be guided by the size of the coming crop. We believe that the old crop months (July and August) will not make new highs regardless, but the focus will shift solely to the new crop months.

On June 17, highly regarded analyst Sparks Commodities threw the market a curve ball by issuing an estimate for soybean acreage of 67.5 million acres, which was 1.3 million acres below the USDA's last estimate. Even more dramatic was their estimate for 1997-98 ending stocks of 123 million bushels, which was 117 million bushels below the USDA! Sparks also estimated this year's carryover at 115 million bushels vis à vis the aforementioned USDA estimate of 130 million bushels. To underscore our earlier point that the market is properly priced, the market greeted this seemingly very bullish news with a muted response. After a brief rally, prices have drifted lower since, old and new crop.

One thing is very clear. Crops have to be in optimum shape to avoid new crop prices zooming right up to where old

crop prices are now. The US grows roughly half of all soybeans in the world, so its crop is the major factor. However, while the US is expected to enjoy a bumper crop, the global crop, although higher than last year is still below the record 1994-95 season by 3.7%. That may not seem to be too much, but when you consider that demand has grown by 2.4% in the same 2-year period, you have the making of deficits.

We can take nothing for granted. The Argentinean crop has been steadily downgraded and is now said to be about 11 million tonnes, compared with an estimate that reached as high 13.7 million tonnes a few months ago. The Chinese crop, based on planting intentions, is expected to grow significantly to 16.3 million tonnes from 12.6 million tonnes. We have thrown around some wild statistics in the past, but it is difficult to measure the rate of growth of Chinese demand and whether this large crop will slow China's need for imports. To give a general idea of how Asian demand has grown, an industry participant said in a recent speech that 65% of the population of India are meat eaters today compared with 45% only 10 years ago, roughly a cool 150 million people. With growth like that, crops have no room for mistakes.

STRATEGY: *Remain sidelined.*

— **Sholom Sanik**

Chart 7

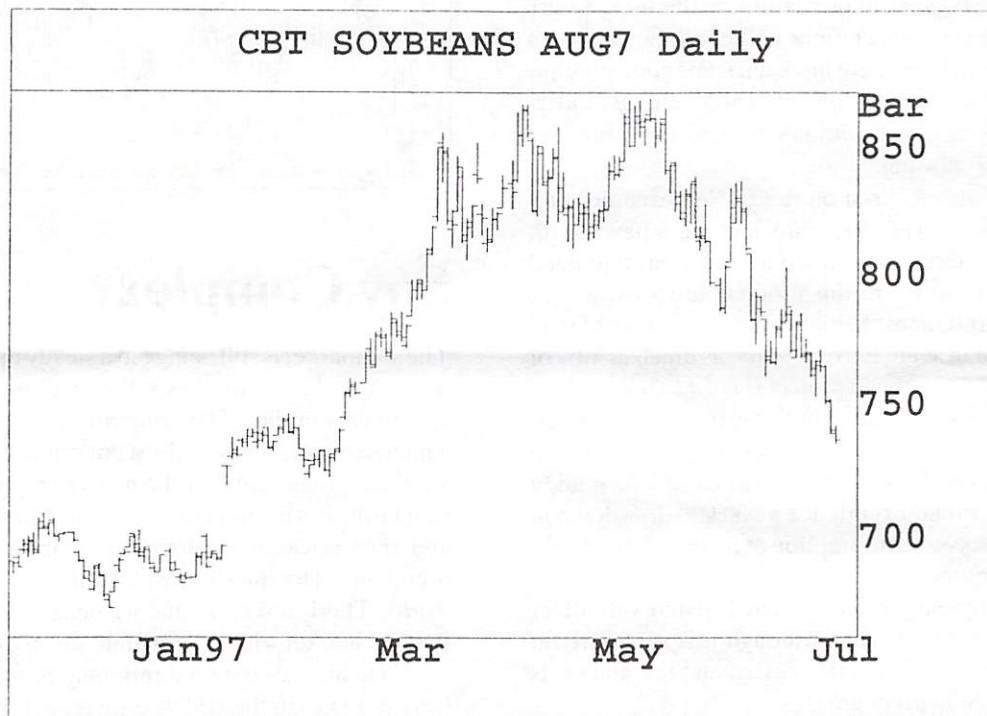


Chart 8 — FOREIGN CURRENCY BONDS

DATE: June 27, 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 PAYMENT
DEUTSCHE MARK DENOMINATED BONDS					
World Bank 7 1/4% 13/10/99 RRSP eligible	106.90	107.75	3.64		Oct-13
World Bank 9% 13/11/00 RRSP eligible	115.30	-	-		Nov-13
Kingdom of Denmark 6 1/8% 15/04/98	101.55	-	-		Apr-15
Argentina 8% 5/10/98	103.25	104.10	4.55		Oct-05
Kgdm. of Spain (6 Mo. LIBOR+1/16) 29/6/02 (semi)	99.80	100.10	-	3.1875	Jun-30
CZECH REPUBLIC KORUNA BONDS					
General Electric Cap. Corp. 10 5% 23/10/98	93.65	-	-		Oct-23
Nordic Inves. Bk 10 625% 10/11/00	93.40	-	-		Nov-10
Intl. Fin. Corp 10% 30/4/98	94.90	-	-		Apr-30
SWISS FRANC DENOMINATED BONDS					
General Electric Cap. Corp. 4 3/4% 2/7/98	102.45	-	-		Jul-02
General Electric Cap. Corp. 4 1/2% 17/12/99	105.00	-	-		Dec-17
DANISH KRONE DENOMINATED BONDS					
Kgdm. of Denmark 9% 15/11/98	106.60	107.45	3.32		Nov-15
ECU DENOMINATED BONDS					
United Kingdom 9 1/8% 21/02/01	114.00	114.85	4.58		Feb-21
BRITISH POUND DENOMINATED BONDS					
European Inv. Bk. 7% 22/12/98	99.50	100.35	6.70		Dec-22
Kgdm. of Denmark FRN 28/8/98 3mo LIBOR-12.5b p. (qtlly)	99.80	100.10	-	6.44141	Aug-28
JAPANESE YEN DENOMINATED BONDS					
World Bank 4 1/2% 22/12/97 (semi) RRSP eligible	101.75	102.60	-		Dec-22
CANADIAN DOLLAR DENOMINATED BONDS					
Eksportfinans 7 3/4% 5/11/97	100.55	101.80	2.28		Nov-05
Ontario Province 10 5/8% 15/7/98 RRSP eligible	105.55	106.80	3.79		Jul-15
Petromet Resources 6.5% 31/3/04 (semi) CV @ \$9.50 p/sh	88.75	90.25	8.42		Sep-30
SOUTH AFRICAN RAND DENOMINATED BONDS					
ESCOM 11% 1/6/08 (semi)	80.45	81.30	14.45		Dec-01
AUSTRALIAN DOLLAR DENOMINATED BONDS					
Toronto Dominion Bk. Aust. 7.25% 26/2/99 RRSP eligible	102.20	103.05	5.25		Feb-26
NEW ZEALAND DOLLAR DENOMINATED BONDS					
World Bank 8.25% 30/4/99 RRSP eligible	102.15	103.00	6.44		Apr-30
New Zealand Gov't 10% 15/7/97 (semi)	99.50	-	-		Jul-15
New Zealand Gov't 8% 15/7/98 (semi)	100.40	101.25	6.73		Jul-15
Ontario Province 7.15% 24/11/98 (semi)	99.95	100.80	6.53		Nov-24
Fletcher Challenge 10.75% 15/12/97 CV (semi)	100.30	-	-		Dec-15
Fletcher Challenge 10.15% 30/11/98 CV (semi)	101.70	102.55	8.19		Nov-30
Tranz Rail Ltd. 10% 15/10/99 (semi)	103.00	-	-		Oct-15
Trans Tasman 9% 27/6/99 CV (semi)	97.05	99.90	10.45		Jun-27
St. Luke 8.7% 1/4/99 (semi) CV @ 1.00 p/sh	165.60	-	-		Oct-01
Kiwi Income Prop. Trust 9% 30/9/03 CV (semi)	128.55	130.55	7.15		Sep-30
ARGENTINEAN PESO DENOMINATED BONDS					
Bocon Pre 1: 1/4/2001	PAR VALUE 132.7331	121.65	123.40	IRR 7.90	Jul-01-97
U.S. DOLLAR DENOMINATED FIXED CONV. BONDS					
Atari Corp. 5 1/4% 29/4/02 CV@16.31 p/sh	47.25	-	-		Apr-29
Coeur D'Alene 6% 10/6/02 CV@ 26.00 p/sh	85.75	87.25	9.34		Jun-10
Sports & Recreation 4 1/4% (semi) 1/11/00 CV @ 25.5 p/sh	70.25	71.75	15.40		Nov-01
The Learning Co. 5 1/2% (semi) 1/11/00 CV @ \$53.00 p/sh	81.75	83.25	11.71		Nov-01
Data General Corp. 7.75% (semi) 1/6/01 CV @ \$19.20 p/sh	137.25	138.75	-1.77		Dec-01
Novacare Inc. 5.5% (semi) 15/1/00 CV @ \$26.65 p/sh	94.25	95.75	7.37		Jul-15
Beverly Enterpr. 7 5/8% (semi) 15/3/03 CV @ \$20.47 p/sh	100.75	102.25	7.13		Sep-15
U.S. DOLLAR DENOMINATED FIXED RATE BONDS					
U.S. Treasury 6.25% (semi) 28/2/02	99.65	99.95	6.26		Aug-31
Queensland Tres. (Gold Bull) 2% 4/3/98	92.75	93.25	-		Mar-04
World Bank 7 1/8% 27/9/99 (semi) RRSP eligible	101.95	102.80	5.77		Sep-27
T.W.A. 12% 3/11/98 (semi)	102.50	103.35	-		N/A
U.S. DOLLAR DENOMINATED FLOATING RATE NOTES					
Canada Gov't 10/2/99 3 mo. LIBOR - 1/4 (qtlly), callable @ 100 RRSP eligible	99.74	100.04	-	5.5625	Aug-13
Bocon 1/4/01 (30 day LIBOR) starts paying May 1, '97	PAR: 127.2944	123.65	-	-	Jul-01-97
Argentina: Series L-FRB 31/3/05, 6 mo. LIBOR+13/16 (semi)	PAR: 97	93.00	94.50	8.25	Sep-30
Venezuela: DCB: 18/12/07, 6 mo. LIBOR+7/8 (semi)		91.90	92.75	8.88	Dec-18

GOLD (in ounces, at market prices, can also be held in your bond account)

client eligibility determined at point of sale.

**Chart 9 — Friedberg Capital Markets
Recommended current portfolio allocations**

1. KIPT 9% cv (NZ\$)	15%	5. Canada FRN (US\$)	30%
2. Novacare Inc. 5.5% cv (US\$)	2.5%	6. The Learning Co. 5.5% cv (US\$)	5%
3. 10 yr. Bunds, hedged (US\$)	12.5%	7. Sports & Rec. 4.25% cv (US\$)	5%
4. US Treasury 6.25% '02 (US\$)	15%	8. Ontario Prov. 7.15% '98 (NZ\$)	15%

HOTLINE UPDATE

Flash Update, Tuesday, June 3, 1997:

Good morning for Tuesday, June 3, 11:00 am. This is a flash update. The market letter is in the mail, and one of its recommendations was to sell short August gold with a 355.00 stop. August gold is presently trading at 346.00.

Tuesday, June 3, 1997:

Good afternoon for Tuesday, June 3. There are no changes or new recommendations.

Flash Update, Thursday, June 5, 1997:

Good afternoon for Thursday, June 5, 5:00 pm. This is a flash update. Buy September Japanese yen and sell September Swiss francs at the market. We suggest that the ideal ratio is 4 yen against 5 Swiss francs.

Friday, June 6, 1997:

Good afternoon for Friday, June 6. There are no changes or new recommendations. The following is a recap of this week's recommendations.

- On Tuesday, June 3, via flash update, we advised that the market letter was in the mail and it had recommended to sell short August gold with a 355.00 stop. August gold was then trading at 346.00.
- On Thursday, June 5, via flash update, we advised to buy September Japanese yen and sell September Swiss francs at the market. We suggested that the ideal ratio was 4 yen against 5 Swiss francs.

Tuesday, June 10, 1997:

Good afternoon for Tuesday, June 10. There are no changes or new recommendations.

Friday, June 13, 1997:

Good afternoon for Friday, June 13. There are no changes or new recommendations.

Tuesday, June 17, 1997:

Good afternoon for Tuesday, June 17. There are no changes or new recommendations.

Flash Update, Thursday, June 19, 1997:

Good afternoon for Thursday, June 19, 5:30 pm. This is a flash update. Buy September cocoa at the market, placing stops at 15.70, close only.

Flash Update, Friday, June 20, 1997:

Good morning for Friday, June 20, 9:05 am. This is a flash update. Liquidate the long Japanese yen/short Swiss franc cross trade at the market. The Swiss is presently trading at .7020 and the yen 88.35, basis the September contract.

Friday, June 20, 1997:

Good afternoon for Friday, June 20. There are no changes or new recommendations. The following is a recap of this week's recommendations.

- On Thursday, June 19, via flash update, we advised to buy September cocoa at the market, placing stops at 15.70, close only.
- This morning, September cocoa opened at 16.38. Also this morning, via flash update, we advised to liquidate the long Japanese yen/short Swiss franc cross trade at the market. The Swiss was then trading at 7020 and the yen at 88.35.

Tuesday, June 24, 1997:

Good afternoon for Tuesday, June 24. There are no changes or new recommendations.

Flash Update, Wednesday, June 25, 1997:

Good afternoon for Wednesday, June 25, 1:30 pm. This is a flash update. Sell December copper at the market, presently trading at 105.50.

Friday, June 27, 1997:

Good afternoon for Friday, June 27. This is a complete summary since our last market letter, dated April 20, of all liquidations of open positions and new recommendations that remain outstanding.

- On Tuesday, June 3, via flash update, we advised that the market letter was in the mail and one of its recommendations was to sell short August gold with a 355.00 stop. August gold was then trading at 346.00.
- On Thursday, June 19, via flash update, we advised to buy September cocoa at the market. Cocoa opened on Friday at 16.38. Place stops at 15.70, close only.
- On Wednesday, June 25, via flash update, we advised to sell December copper at the market, then trading at 105.50.

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