FRIEDBERG'S

COMMODITY & CURRENCY COMMENTS

Friedberg Commodity Management Inc. | Volume 18, No. 8 | September 28, 1997

Liquidity is just a state of mind

We often hear that financial asset prices cannot go down because there is so much money "out there" or "sloshing around." The more colorful types have even spoken of a "wall of money," conjuring up pictures of rivers and torrents of money washing off the shores of Wall Street. Can this be true in a real sense? Is there so much more money today than there was 5, 10, 15, or 20 years ago? Before we answer this question, we need to draw an obvious and simple distinction — one between stocks and flows. Money supply, narrow or broad, is a stock. Wealth is a stock. *Changes* in money supply are flows and so is GNP, or national income.

Money flows in recent years have been rather moderate, with the broad stock of money rising on average by not more than about 5% per annum. In dollar terms, M2 rose less than $20 billion over the past 12 months, a figure that pales in comparison with, say, Ted Turner's billion dollar increase in net worth (via his holdings in Time Warner) over the past 9 months. More comparably, the $20 billion increase in M2 is still much smaller than the $25 billion or so that flow *monthly* into US mutual funds. Here one may justifiably ask, from where? And the answer is crucial to an understanding of today's liquidity crux.

Very simply, people's aversion for risk has progressively diminished. This is both a result of and a cause of the longest bull market in history. With the diminution of risk aversion we have witnessed a massive and historic shift of funds from fixed-rate to variable-rate returns that has created the impression of a veritable tidal wave of money. The greater risk-seeking activity of the public has naturally lifted stock prices, and the price of lower-quality credit instruments; price-earnings ratios have soared, and credit spreads have collapsed.

What caused this paradigmatic shift in risk appreciation? Three factors, in our view.

First and foremost is the sharp fall in nominal yields that began with the end of the Great Inflation in the early '80s and was accelerated by the Fed's super-easy monetary policy in 1992-93. The "sticker shock" phenomenon (refusing to renew maturing deposits at lower and lower yields) of the early '90s assumed, correctly in our view, that the public was unable or unwilling to differentiate between falling *nominal* and relatively stable *real* yields. Admittedly, there is little doubt that at some point — in particular 1992-93 — the public sensed that real yields were negative.

Second, the persistence of the bull market of the '80s, which was only catching up to the huge asset inflation of the '70s. Its durability began to create, among the younger generation, the impression that equities could only go up. Thirdly, the Mexican bailout, a signal that the-powers-that-be would never allow a major emerging economy to fall and much less a localized financial crisis from spreading globally.

"Moral hazard," as economists like to call it, provided a powerful incentive to step down the slippery slope of risk aversion, with the result that hundreds of billions of dollars have flown from developed countries to less developed ones in just three short years.

Liquidity with respect to speculative assets is no more and no less than the willingness of investors to step up to the plate and accept greater risks. Conversely, illiquidity occurs when routine sellers find buyers backing away from accepting greater risks. In the former case, speculative positions can be sold at rising prices; in the latter, speculative positions can be sold only at declining prices.

Liquidity and illiquidity, then, are a function of willingness to accept risk. They are *states of mind*. It matters little how much new money is created or even how much money is

In this issue

Contributions by Albert D. Friedberg, Dr. Steve H. Hanke, and Sholom Sanik.

destroyed, the equivalents of money supply growth and contraction respectively. The feeble $20 billion annual increases in broad money supply is irrelevant to our discussion of liquidity.

It is interesting to note the growing share that common stocks are taking in the liquid portfolios of the US public: In the months before the crash of 1987, common stocks represented 65% of the combined value of M2 plus common stocks. Now the proportion of common stocks to total liquid assets (M2 plus common stocks) has grown to 72%. The public holds now 2½ times more common stocks, at today's prices, than currency, checkable deposits, and fixed-term deposits. This is no mere curiosity, as wealth represented by common stocks is variable and only as good as the last ticker tape quote.

Digressing a bit further, we also note that the savings rate in the US has declined to the lowest level in 50 years (see Chart 1), clearly on the back of this dramatic rise in wealth. But at the risk of overemphasizing the point, wealth is far less reliably secure in September 1997 than in July 1987.

One might be tempted to ask whether, in fact, a relationship exists between the value of all common stocks and M2 type deposits beyond which one could safely predict that a limit has been reached. The answer of course is negative. As long as the holders of these deposits are willing to accept progressively greater risks, a roughly unchanged stock of money will be able to support higher and higher valuations of variable-return assets. Note that money going into common stocks does not vanish into a black hole. It reappears in the balances of the seller. The money stock is simply recycled.

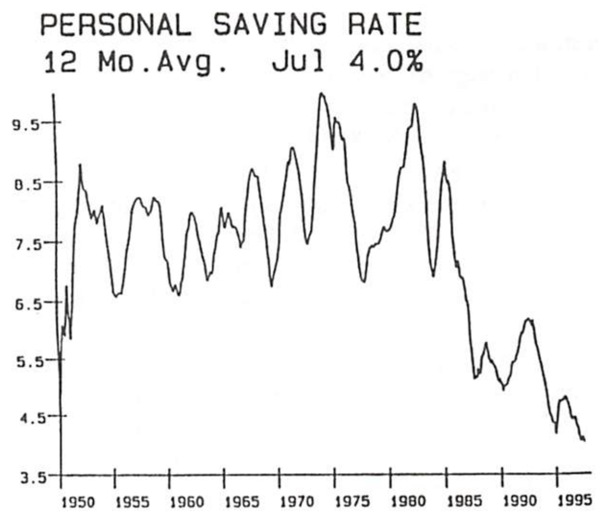
The state of mind that causes the fabulous liquidity that we enjoy today can change only when bets begin to go awry and losses begin to mount. This is the significance that the Southeast Asian crisis has acquired.

The crisis has impaired the capital of a very large number of emerging market players and has done so beyond their wildest imagination. As the crisis spreads — and as sure as night follows day it will — to the Japanese banking system, already tottering on the brink of insolvency, to Colombia, Brazil, and then the rest of Latin America, and finally to Central Europe and Russia, the willingness to take today's risks will diminish.

As consumer credit losses continue to mount, the willingness to make loans at today's spreads will diminish, too. As consumers, starved out of credit, retrench, corporate loses will mount. Mounting losses will dry up liquidity on a global basis, even without the Fed lifting a finger, or hoisting rates (but see our discussion on interest rate futures and our assessment of potential increases in the Fed Funds rate). With investors turning tail, liquidity will vanish, and shares, and low grade/high-yield securities will need to be marked down. As security losses mount, illiquidity will become critical, and only the best and the safest (Treasury securities?) will survive and prosper.

The "wall of money" is not real. It is a product of our animal spirits.

Chart 1



ISI Group

THE FAR EAST

Asia's deflation, trouble ahead

by Steve H. Hanke

During the past few months, the major stock markets around the world have become volatile and trendless. The Dow, for example, is more volatile — measured in terms of the frequency of days it has moved more than one percentage point up or down — now than in any time since 1987. This means that there is a wide conflict of views between the bulls and bears. It also should serve as a warning that there is trouble ahead.

Where will the trouble come from? It will come from Southeast Asia. While most observers assert that the recent currency troubles in Southeast Asia are small potatoes compared with Mexico's peso fiasco, I disagree. The Asian problems are much more worrisome.

One reason why the problems in Asia are so troubling hinges on the fact that the economies in Southeast Asia, particularly their export potential, are so much larger than Latin America's. The export of goods and services accounted for by Japan, China, the four tigers, and the 24 developing Asian economies equals almost 25% of the world's total. The 34 Latin American countries account for only a little over 4% of the world's total.

What, then, constitutes the source of Asia's problems? The Asian economies are in the grip of a massive deflation, with Japan leading the pack. Even though the discount rate at the Bank of Japan has been 0.5% for some time, the Japanese economy is in a slump, with the GDP declining by 2.9% in the 3 months before June 30. This is an annualized decline of 11.2%, the biggest drop since the downturn caused by the oil price shock of 1974. Not surprisingly, Japan's inventory-to-shipments ratio jumped at a 30% annual rate during the second quarter. And the Japanese long-bond yield plunged to a record low of 1.88% in Tokyo last week. This dismal performance would have been worse were it not for a huge increase in Japan's trade surplus, which has been boosted by the recent weakness of the yen against the US dollar. But, the anticipated slowdown in Japan's exports to other Asian countries, which account for 40% of Japan's total, promises to dim even that bright spot.

The situation in the rest of Southeast Asia is almost as deflationary as in Japan. With the recent currency devaluations in the region, speculative real estate bubbles have been pricked, the balance sheets of many financial and nonfinancial enterprises have been exposed, and bankruptcies are increasing rapidly. Also, the region has a huge excess productive capacity, and warehouses are bulging with unsold manufactured goods.

The potential fallout from these deflationary forces is significant, much more significant than Mexico's infamous tequila effect. With dampened domestic demand, devalued currencies, excess productive capacity, and large unsold inventories in most of Southeast Asia, the rest of the world can anticipate to be hit by a surge in exports and fierce competition from Asia. In consequence, enterprises in the rest of the world will see what little pricing power they have wither away. Add to this the slow but steady increase in their costs, and you have a squeeze on profit margins. That brings us back to those volatile, trendless stock markets. Given the deflationary forces at work in Southeast Asia, there is only one way for the Dow to break, and that is down. Such a break will send shock waves throughout global capital markets, particularly the emerging markets.

By why is Japan in the grip of deflation and a classic Keynesian liquidity trap? To unravel this mystery, you must follow the advice of Morgan Stanley's sage, Barton Biggs. Namely, you must stop compulsively reading the daily bulletins issued about Japan and turn your attention to some serious reading material. But what? Fortunately, Professor Ronald I. McKinnon and Kenichi Ohno have written a new book, *Dollar and Yen: Resolving the Conflict between the United States and Japan*, MIT Press, Cambridge, Massachusetts ($39.50). That is just the type of high-quality material that Barton Biggs would embrace. Even though it will take a few days to digest, the McKinnon-Ohno tome is a "must read."

The observations and conclusions drawn from the outstanding, original theoretical and empirical analysis of McKinnon and Ohno are as follows:

1. The yen stayed comfortably at its Bretton Woods parity of 360 yen to the dollar (plus or minus 1%) from 1949 to 1971.
2. Since 1971, the yen rose persistently, if erratically, against the dollar. The authors refer to this as the syndrome of an ever-higher yen.
3. The study of international finance — the implications of monetary and fiscal policies for exchange-rate determination — is traditionally separated from the study of trade flows, commercial policies, and trade disputes. This dichotomy is not valid for the study of the peculiar US-Japan macroeconomic relationship since 1971. Indeed, the authors show that the yen syndrome, from 1971 through at least April 1995, has been driven by commercial tensions, including US threats of trade wars. And, on occasions when those threats were relaxed, as in the summer of 1995, the yen fell.
4. McKinnon and Ohno show that the conventional paradigm for floating exchange rates has not been valid during Japan's floating era (1971 to present) — and independent monetary policy has not determined the yen's exchange rate. Rather, the yen-dollar exchange rate has been a forcing variable for Japan's monetary policy.
5. McKinnon and Ohno, therefore, identify two important and peculiar causal chains for Japan — from mercantilist pressure to the yen-dollar rate, and from this exchange rate to Japanese monetary policy.
6. In consequence, McKinnon and Ohno can explain the yen syndrome. Contrary to all the free-trade chatter in Washington, the US commercial relations with Japan are mercantilist. Since 1971, the US has, during most the time, pressured Japan to have a stronger yen. To insure this result and to avoid trade wars, the Bank of Japan has followed deflationary policies relative to the US. As the US has deflated, Japan has been forced to live with a maxi-deflation, and its economy has finally imploded.

At present, the US-Japanese commercial relations are on a razor's edge, and the US, which calls the monetary tune in Japan, is on the horns of a dilemma. The US-Japan bilateral trade balance is ballooning in favor of Japan. Hence, the recent mercantilist rhetoric from Washington. Much more of this pressure and the yen will strengthen, the Bank of Japan will become more deflationary, and the Japanese economy will continue to spiral downward, something the US desperately wants to avoid. On the other hand, if the US backs off its mercantilist rhetoric, the yen will weaken, and its trade deficit with Japan will grow, something the US also desperately wants to avoid. It's not a pretty picture, is it?

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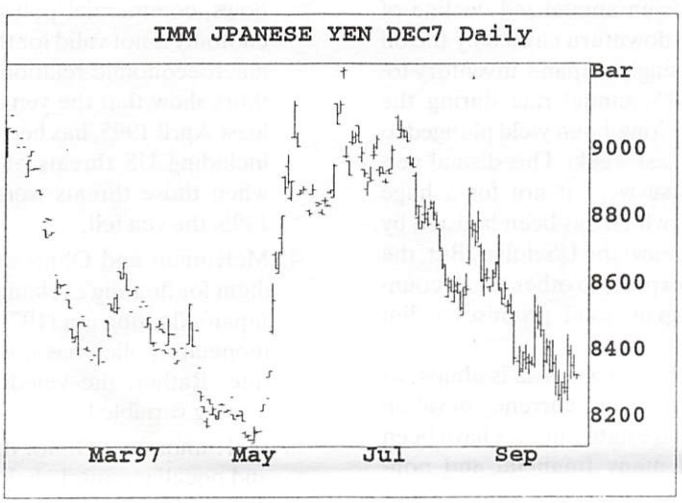
STRATEGY: *As the article makes clear, the US is exerting considerable political pressure on Japan to force the latter to maintain a cyclically overvalued exchange rate. At the same time, the US administration has of late become more aware of the dangers of a Japanese depression/deflation, which dictates, of course, a more benevolent attitude to a wider trade surplus. The former viewpoint is more likely to prevail the closer one gets to the next US election. The latter viewpoint could become critical in coming months. This Molotov cocktail augurs for a highly volatile exchange rate (subject to conflicting and frequent verbal interventions), tracing a mildly declining path. We advise selling short-term, slightly out-of-the-money yen call options.*

Chart 2



INTEREST RATE FUTURES

A Fed Funds rate increase in the offing?

Inflation continues to run at a moderate pace throughout the industrialized world. Given that inflation is fundamentally a monetary phenomenon — a fact acknowledged by US Federal Reserve Board Chairman Alan Greenspan — much of the credit can thus be attributed to moderate rates of growth in the monetary aggregates combined with significant gains in productivity. Or so it would appear.

Our own assessment is that the Fed has been too easy for well over 10 years — and more particularly for the past 5. Beneath the moderate expansion in the broader monetary aggregates lies the almost incontrovertible fact that the demand for transactional balances has actually been falling, the result of credit cards and generally improved technologies. Yet, during the first half of the '90s, the Fed increased the adjusted monetary base by well over 7.5%. From the end of 1995 to the present, the adjusted monetary base grew by over 4%.

Rising supply in the face of falling demand spells excessive monetary ease. This assertion is further demonstrable by the existence of a positive yield curve that is both more persistent and steeper than any time in this century.

Be that as it may, the more conventional view that focused on the broader measures such as M2 and M3 was that the expansion was indeed moderate: Annual rates of growth for M3 did not increase beyond 5% per annum (until mid-1995) and ranged as low as -0.8% (early 1993). Since then, however, monetarists have pointed out that the broader aggregates are misbehaving: M2 growth has picked up to almost 5% since mid-1995, while M3 has recently hit a 9% annual rate. Even the adjusted monetary base has accelerated to a 7% annual rate, proof that interest rates are being set much too low.

In his September 5 speech at Stanford University Mr. Greenspan expressed doubt as to "which financial data should be aggregated to provide an appropriate empirical proxy for the money stock that tracks income and spending." Regardless, the Fed would be hard pressed to ignore such a significant acceleration in the three most important measures of the money stock.

While commodity prices, and in particular industrial commodities, have been weak of late, do these the prices matter? As Mr. Greenspan himself asked:

"But what about prices of claims on future goods and services, like equities, real estate or other earning assets? Is stability in the average level of these prices essential to the stability of the economy? Recent Japanese economic history only underlines the difficulty and importance of this question. The prices of final goods and services were stable in Japan in the mid-to-late 1980s, but soaring asset prices distorted resource allocation and ultimately undermined the performance of the macro-economy." Underscoring his concern, he then added:

"...But, unless they are moving together, prices of assets and of goods and services cannot both be an objective of a particular monetary policy, which, after all, has one effective instrument — the short-term interest rate. We have chosen product prices as our primary focus on the grounds that stability in the average level of these prices is likely to be consistent with financial stability as well as maximum sustainable growth. History, however, is somewhat ambiguous on the issue of whether central banks can safely ignore asset markets, except as they affect product prices."

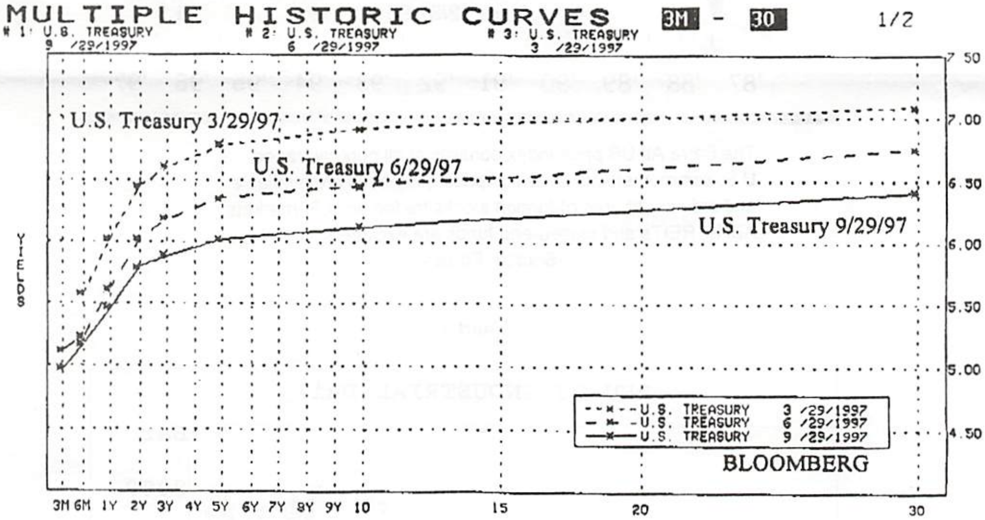
To make matters even more bewildering, he notes that "the simple notion of price has turned decidedly complex. What is the price of a unit of software or of a medical procedure? How does one evaluate the price change of a cataract operation over a 10-year period when the nature of the procedure and its impact on the patient has been altered so radically? The pace of change and the shifting to harder-to-measure types of output are more likely to quicken than to slow down. Indeed, how will we measure inflation in the future when our data — using current techniques — could become increasingly less adequate to trace price trends over time?"

Despite his denial, Fed policy seems to have gone adrift. It has no monetary anchor. It is not confident that producer prices should be the focus of its concern and in fact believes that price stability will become increasingly harder to measure as the notion of price itself has turned "decidedly complex."

An eclectic and discretionary policy will have eventually to take note, if not of asset prices, then surely of exploding monetary aggregates. An increase in the Fed Funds rate is becoming a necessity: While initially the entire yield curve will reflect the dearer conditions, the curve should invert further (see Chart 3). And long bonds will be well on their way to yielding 5.5%.

STRATEGY: *Stand by to take trading profits on long T-bond positions. On the next dip, we should become aggressive buyers of 30-year maturities.*

Chart 3



S&P 500

The message of the tape

Strangely enough, it is getting easier to put on a short position. We are at a loss to describe why this is so. But clearly, for the first time in years, a bear does not get trampled. The market seems to lack the old time vigor, that oomph, so much present in previous recoveries. The "Nifty Fifty" look tired, so does the Dow Jones Industrial Average and even the S&P 500. The August 7 peak has as yet to be bettered, even though the background news could not be better.

Stocks have become highly vulnerable. Third-quarter earnings will almost surely disappoint — either because they will be worse than expected or because they will be thought to have achieved the high-water mark for the present expansion. Even double-digit earning gains through 1997-98 cannot "cheapen" the S&P 500: Based on these forward one-year earnings projections, it is selling at a price-earnings ratio of around 20, its highest level in three decades.

More signs of vulnerability: A very large number of big capitalization stocks are currently trading at valuations greater than 2 times their 5-year expected growth rates, violating the old and sensible rule of thumb that a stock should sell at about its expected growth rate.

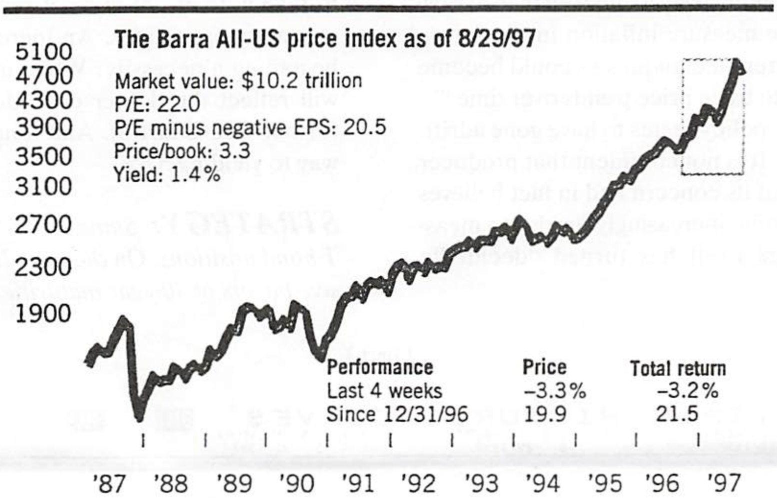
Then there is the usual litany of bearish factors — those that make a bear feel good just before he gets stopped out: Insider transactions are running heavily on the sales side; sentiment has gotten as bullish as it can when one finds that fund investors' holding period is down to 2½ years from 12½ years on average 25 years ago; dividend yields for the S&P 500, after adding cash received from shareholders from buybacks, is at only 2.2%, still the lowest in at least 22 years. And so on.

Most important of all, however, is the tape. Not that we fancy ourselves resembling the legendary Jesse Livermore, but it sure seems that the path of least resistance points South.

Have we seen the top?

STRATEGY: *Sell, with great trepidation. You need risk only the Dow Jones Industrials high of 8299, close only.*

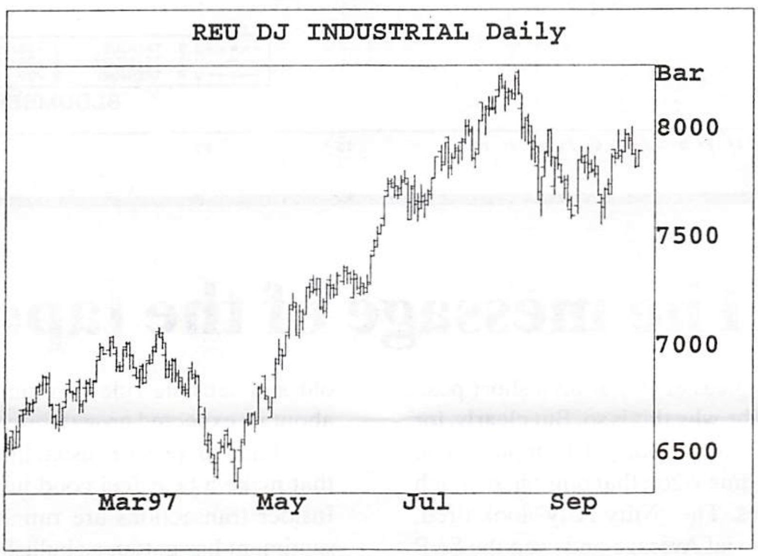
Chart 4



The Barra All-US price index consists of all publicly traded U.S. common stocks for which price quotations are available and ordinary shares of foreign stocks traded on U.S. markets. ADRs, REITs and closed-end funds are excluded.

Source: Forbes

Chart 5



GOLD

Another pause in a continuing downtrend

Rumors of strong increases in fabrication demand — later confirmed — gave the market enough ammunition to mount the third rally off the 317-320 lows first reached in July. The buying was reinforced by unnerved shorts unable to positively identify the recent (central bank) seller of 200 tonnes of the yellow metal. Both indications were provided by Gold Fields Mineral Services consultancy in their semi-annual *Gold Update*.

The review had an optimistic tinge. Gold fabrication demand, mainly for jewelry, rose 15.1% to 1,857 tonnes in the first 6 months of the year from 1,613 tonnes in the year earlier period. Gold bar hoarding increased 67% to 167 tonnes. In all, total demand rose by 17.1% to a record 2,028 tonnes, leaving a gap of 597 tonnes between mine supply and demand. The shortfall was made up by an estimated 220 tonnes of net central bank sales, forward sales by producers, who supplied 131 tonnes, option hedgers 61 tonnes, and short sellers (primarily) 189 tonnes.

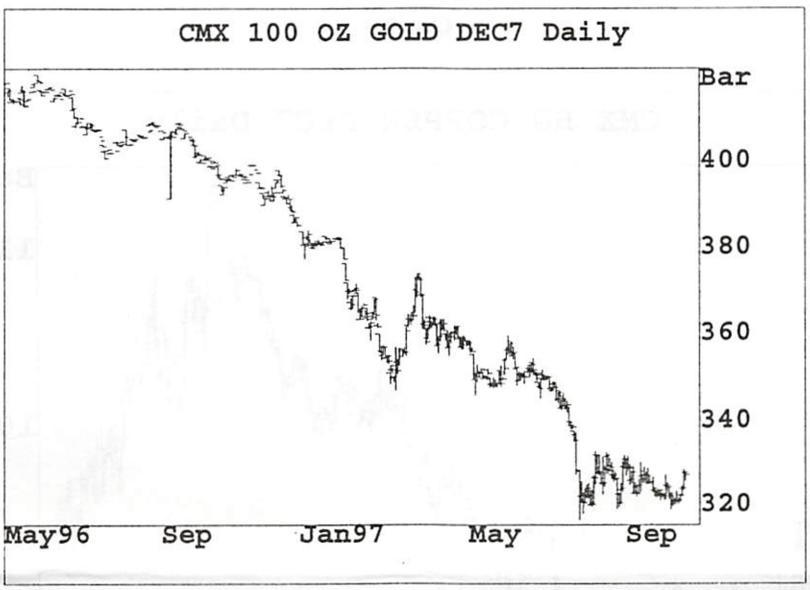
Nevertheless, the author of the report was hopeful that hedge selling would slow down as nearly half of the world's gold mines were not profitable at current prices and would thus seem less anxious to remain short at such levels. The author concluded that "the possibility of the price being forced down to the $280 [an ounce] level, which appeared to induce panic among some producers a few months ago, now looks excessively pessimistic."

The two flies in the ointment are the following: The faster rates of official disposals (estimated sales are just 19 tonnes less than all of last year), indicating a growing acceptability to demonetize; and the 1.4% increase in mine output in spite of the low prices. As we indicated in earlier issues, mine production will have to decline significantly in coming months to accommodate accelerating central bank sales, unless of course demand continues to grow at the recent pace. In this respect, one would have to guess that the spreading Southeast Asian financial and economic crisis will affect wealth and future gold consumption negatively.

What the numbers do demonstrate is that the basic fundamentals of the gold market are extremely constructive. When the demonetization overhang is resolved, gold will shine. For now, however, the downtrend is still in force though with intermittent rallies designed to shake off as much company as possible.

STRATEGY: *Traders were advised to cover outstanding short positions via a flash update. Keep in close contact for re-entry advice.*

Chart 6



COPPER

Early stages of the bear

The two most widely available statistics for monitoring the state of copper supplies have been a bear's delight. Watching the addition of 3,000 tonnes each morning to LME warehouse stocks has become, like morning coffee, both comforting *and* expected. Only a few months ago, back in July, the spread between cash and 3-month copper was in backwardation at $248 per tonne. Today it sits at a $28 contango. The supplies from the growing operations in South America and elsewhere are coming to market.

Chilean output figures, reported monthly by their central bank vis à vis the same month for the previous year were up for both July and August. Even after adjusting for higher prices this August over last, export volume rose by roughly 26%.

In a market starved for reliable information, a refreshingly candid report popped up from the private sector. We call it "candid" because copper producers benefit from rising prices, and the release of a bearish report can hardly be considered biased. In a presentation to the Dean Witter/Morgan Stanley Metals Conference last week, Asarco's CEO Richard Osborne raised his company's forecast for 1997 output to 12.6 million from 12.3 million tonnes. In addition he lowered Asian consumption by 140,000, or 9.9%. This is a quick response to lower growth rates that appeared in Southeast Asia in the third quarter. The net effect is that the company's August 1 forecast for a 1997 supply/demand deficit of 34,000 tonnes turns into a surplus of 15,000 tonnes. For 1998, Asarco's forecast for a deficit of 173,000 tonnes becomes a deficit of only 108,000 tonnes.

Not that we need the company, but where months ago most analysts were talking about deficits, they are now beginning to see things our way. Bloomsbury Minerals Economics says it has created a new, more accurate method for counting supply and demand. It will smooth out some of the problems inherent in keeping track of global flows of copper. The new system shows a global "...surplus existed last year and will continue up to and including 1999."

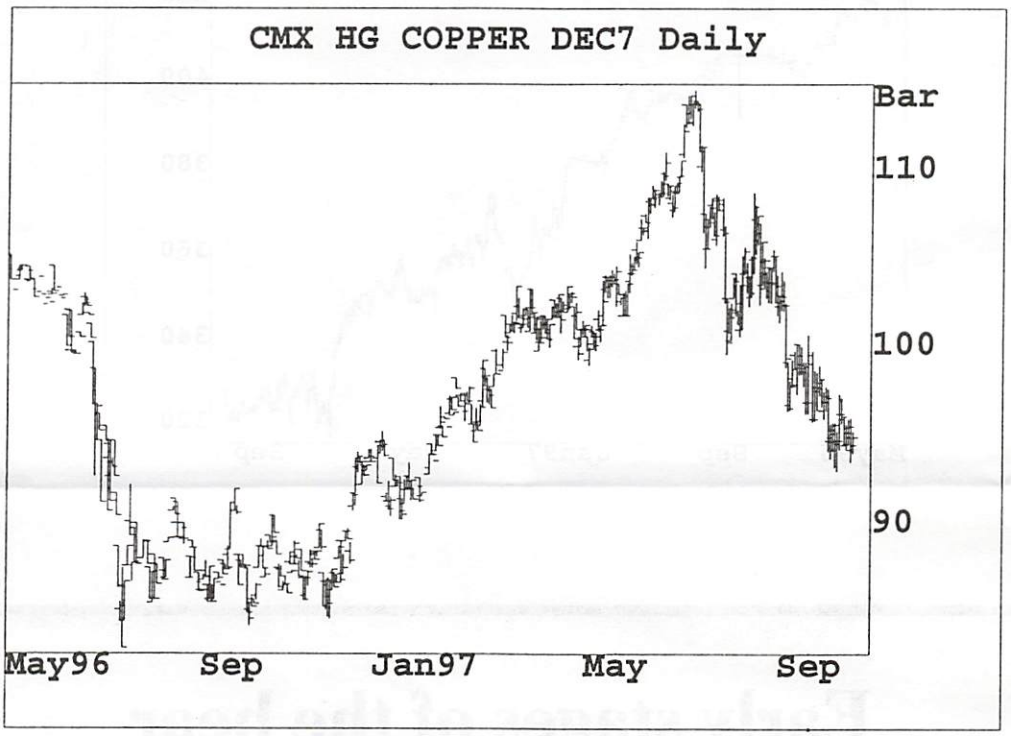
Bulls were counting on China to bail them out. In fact the figure of 200,000 tonnes (refined) of expected Chinese purchases probably was not far from what they actually purchased. Some analysts say that 190,000 tonnes have actually arrived. This does not leave much room for further buying. The figure at which the Chinese are said to show an interest in is at $1,900 a tonne. Spot copper closed in London last week at $2,100. That is quite some distance.

The slide over to the surplus side by many analysts has shown up in the sentiment numbers that we watch. Prices have not made that much downside progress in the past few weeks and are forming a bit of a base. We view this as a consolidation in the early stages a bear market. The market could work off the slightly oversold condition by moving sideways and tiring the uncommitted bears.

STRATEGY: *Remain short and maintain stops at 99.35, close only, or 101.00, good anytime, basis December '97.*

— Sholom Sanik

Chart 7



SOFT COMMODITIES

Cocoa

Unless the computer that generates the weekly charts on our screens is seriously messed up, cocoa prices bottomed out in 1992 and have been rising since. The period between 1992 and 1994 was spent consolidating the floor between $900 and $1,100 a tonne. The market spent less than a year connecting the $1,100 level to the next rung on the ladder. Then the market traded for 3 years between $1,200 and $1,400 a tonne, bringing us to the new post-$1,400 a tonne era.

The point of this brief history lesson is to show that long before traders even dreamed of the El Niño of 1997, the market recognized that the years of glut would not last forever. This tropical plant, grown commercially in only a handful of countries, is constantly vulnerable to a rapid disappearance of supply by crop failure, a surge in demand, or a combination thereof.

To be sure, we are not scoffing at El Niño, not at all. As a matter of fact, among the markets we trade, there is probably no market that is more open to a direct hit from El Niño. All the other crops that can be affected by El Niño have potential substitutes — vegetable oil and carbohydrate feed for example. Furthermore, other crops are grown all over the world, North and South, East and West hemispheres. An unfavorable weather system in one region may mean a better one in another 5,000 miles away.

Cocoa is grown primarily in three regions: West Africa, Southeast Asia, and South America. South America means Brazil, and you could almost forget about it as a major player, because disease, as well as other factors, have seen its output dwindle from a proud, exportable 400,000 tonnes per annum to below 200,000 tonnes. This leaves the African and Asian regions. The bigger and more important crops in the Ivory Coast, Ghana, and Nigeria seem to be on track for the moment, although it is quite early in the growing season. However, dry conditions have appeared in Indonesia and Malaysia. As we point to in our discussion of soy oil, meteorologists are united in assessing this area as the most vulnerable for drought. Malaysian crops have been consciously allowed to dwindle, because the country's producers find palm oil crops more profitable. Indonesia, though, should be the swing factor in determining the fate of the supply/demand balance. Crop size has been growing steadily in the past 10 years, and the market is counting on them. The Ivory Coast may be the biggest producer, but its production is not expected to surpass last year's output.

If El Niño does take a bite out of Indonesian production, it would make some of the bleak predictions being tossed around by some analysts quite bullish. On September 25, ED & F Man, which had been predicting a deficit of 142,000 tonnes without El Niño, repeated its warning that El Niño could bring the deficit to as high as 450,000 tonnes.

Nonetheless, we maintain, El Niño would be only the icing on the cake. The demand figures we use to determine the world supply/demand balance still come from grinding figures. As grinding operations are shifting to origin countries, these figures are probably not very accurate. The true trend of consumption can be seen in rising prices, as illustrated in our historical overview of prices.

Another interesting item has come to light in the past few days. The Ivory Coast has sold forward as much as 850,000 tonnes of the 1997-98 crop, well above the amount required by the IMF, taking a huge source of price-depressing selling pressure off the market. We watch the tape for our cue.

STRATEGY: ***Remain long, leaving stops at 1605, close only, basis December '97.***

Soy Complex

The *1996-97* bull market in soybeans is over. There is a new and record-size US crop in the ground. Early planting intentions indicate another record crop in Brazil, the second most important exporter. The key, however, lies in the italics. The price of new crop beans never reached anywhere near the level of the 1996-97 old crop prices. November peaked at $7.50 per bushel vs. a high of just over $9.00 for old crop. There is, of course, a relationship between the two crops in the carryover stocks, and to be sure, the link is, if anything, bullish. Will the bountiful new crops make $6.50 per bushel look expensive down the road, or will the insatiable Asian demand give us a sequel to last season's bull run?

The supply side is fairly clear. US farmers should harvest a record 2.746 billion-bushel crop, which would be 15% higher than the 1996 crop. The only factor that stands in front of the bounty is concern that some wet weather that is moving across the Midwest could slow the harvest. This fear, like much weather talk, is an annual rite of the autumn harvest season. The soybean is a tough and hardy plant. The harvest, a bit sooner or a bit later, will be fine.

While the supply side has changed, the demand side, probably has not. It's an old, familiar story that reads...China, China, China. On August 20 a report was released by the US attaché at the US embassy in Shanghai on the state of the poultry industry in China. While not considered to be official USDA data, we assume the information is objective. Here are some highlights from the report about those soymeal eating birds:

- Chinese poultry inventory ranks number one in the world, achieved by a rapid growth rate in production, which is forecast at 10% in 1997 alone.

- Demand is coming from both domestic and export markets.

- The Chinese poultry industry takes its export potential quite seriously, evidenced as plants and breeding practices are modeled after Western standards made possible by joint ventures with Western corporations.

- And for the domestic side, the Colonel and the Golden Arches are becoming familiar icons north and south of the Yangtzee River, as KFC has opened more than 150 outlets and McDonald's 120 outlets all across China. Chinese tastebuds are craving Stateside cuisine.

The report dealt primarily with poultry, but let us not forget that over half of the world's protein-feed-eating hogs live in China as well. Western breeding practices also increase the proportion of protein feed fed to hogs and broilers. China's more primitive methods would have the animals eating almost exclusively carbohydrates.

Thus, unlike the production side of the scale, the Chinese situation has not changed its bullish structure. As we pointed out many times last season, it is a trend that can continue for years until a proper balance is found. Until then, soybean prices will be vulnerable. Only the flow of actual export commitment data and the efficient market's treatment of such data will let us know where we stand. The past six weeks have seen export commitment for soybeans come in at or above expectations. At this pace the USDA is well within its rights to predict a 945 million bushel export figure; perhaps it is even a bit conservative.

While meal demand gave birth to the bull market in beans, there is another angle on the soy complex that could operate wholly independent of soy dynamics. Soybean oil prices have languished miserably in the cellar of the commodity pits at the Chicago Board of Trade for years now. Healthy palm oil crops were supplying the demand for vegetable oil quite well. The huge amount of crushing capacity was keeping the demand for meal satiated but was creating a glut of soy oil stocks. Much supply and so-so demand, a perfect formula for depressed prices.

For the moment, the statistics don't show much sign of change. Total global vegetable oil production is expected to grow 1.8% this year, while consumption will grow by 3.1%, causing a subtle drawdown in stocks. However, a not so subtle drawdown could be in the offing. Palm oil is vital to world trade. To get an idea of how vital, consider that in 1996 Malaysian palm oil exports alone were 7.5 million tonnes compared with a combined 3.9 million tonnes of soybean oil from the 3 largest producers of soybeans, Argentina, Brazil, and the United States.

El Niño has received a lot of coverage. One wonders if it is not overblown, and even for those markets where it is not, have those markets already installed an El Niño premium? While we are clearly not meteorologists, it does seem from what we read and hear that the most vulnerable spot on the globe for El Niño-induced drought is the South Pacific.

It would follow then that those crops that have a strong presence in that area and account for an outsize proportion of world dependency would be vulnerable. Prices of palm oil futures have risen some 10% since July, as traders in Kuala Lumpur are taking the threat seriously. The major beneficiary would be US soy oil prices, because global demand will look for substitution.

An interesting wrinkle on this is that the bumper crop of soybeans in the US will not be that effective in combatting declining supplies of palm oil. Anne Frick of Prudential Securities in her August 26 *Quarterly Outlook, Soy Complex,* points out that "Because soybeans have a high meal content relative to other oilseeds, the sharp increase forecast in soybean production should boost potential soybean meal output much more sharply than potential oil production." The implication is that if the world comes knocking for American soybeans with which to produce soy oil, stocks will be drawn down rapidly.

This idea has been discussed by analysts and is no great secret. The open interest in soy oil shows we have company. We await the proper technical signals.

STRATEGY: *Stand aside.*

— Sholom Sanik

Chart 8 — Friedberg Capital Markets
Recommended current portfolio allocations

1. KIPT 9% cv (NZ$)	15%	5. Softkey 5.5% cv (US$)	5%
2. U.S. Treasury 6.375% '27 (US$)	15%	6. 10-year BUNDs, hedged (US$)	12.5%
3. US Treasury 6.25% '02 (US$)	37.5%	7. Canada FRN '98 (US$)	10%
4. Trans Tasman 9% '99 (NZ$)	5%		

Chart 9 — FOREIGN CURRENCY BONDS

DATE: September 26, 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		105.25	106.10	4.06		Oct-13
World Bank 9% 13/11/00 RRSP eligible		113.40	-	-		Nov-13
Kingdom of Denmark 6 1/8% 15/04/98		100.40	101.25	3.66		Apr-15
Argentina 8% 5/10/98		102.50	103.35	4.53		Oct-05
Kgdm. of Spain (6 Mo. LIBOR-1/16) 29/6/02 (semi)		99.87	100.17	-	3.09375	Dec-29
CZECH REPUBLIC KORUNA BONDS						
General Electric Cap. Corp. 10.5% 23/10/98		95.65	-	-		Oct-23
Nordic Inves. Bk 10.625% 10/11/00		94.20	-	-		Nov-10
Intl. Fin. Corp 10% 30/4/98		96.40	-	-		Apr-30
SWISS FRANC DENOMINATED BONDS						
General Electric Cap. Corp. 4 3/4% 2/7/98		101.50	-	-		Jul-02
General Electric Cap. Corp. 4 1/2% 17/12/99		103.90	-	-		Dec-17
DANISH KRONE DENOMINATED BONDS						
Kgdm. of Denmark 9% 15/11/98		104.45	105.30	4.06		Nov-15
ECU DENOMINATED BONDS						
United Kingdom 9 1/8% 21/02/01		112.45	113.30	4.77		Feb-21
BRITISH POUND DENOMINATED BONDS						
European Invt. Bk. 7% 22/12/98		98.95	99.80	7.14		Dec-22
Kgdm. of Denmark FRN 28/8/98 3mo LIBOR-12.5b.p.(qtly)		99.78	100.08	-	7.1875	Nov-28
JAPANESE YEN DENOMINATED BONDS						
World Bank 4 1/2% 22/12/97 (semi) RRSP eligible		100.30	101.15	N/A		Dec-22
CANADIAN DOLLAR DENOMINATED BONDS						
Eksportfinans 7 3/4% 5/11/97		99.70	100.95	N/A		Nov-05
Ontario Province 10 5/8% 15/7/98 RRSP eligible		104.05	105.30	3.63		Jul-15
Petromet Resources 6.5% 31/3/04 (semi) CV @ $9.50 p/sh		91.25	-	-		Sep-30
SOUTH AFRICAN RAND DENOMINATED BONDS						
ESCOM 11% 1/6/08 (semi)		82.75	84.25	13.86		Dec-01
AUSTRALIAN DOLLAR DENOMINATED BONDS						
Toronto Dominion Bk. Aust. 7.25% 26/2/99 RRSP eligible		103.20	104.05	4.19		Feb-26
NEW ZEALAND DOLLAR DENOMINATED BONDS						
World Bank 8.25% 30/4/99 RRSP eligible		101.85	102.70	6.36		Apr-30
New Zealand Gov't 8% 15/7/98 (semi)		99.90	-	-		Jan-15
Ontario Province 7.15% 24/11/98 (semi)		98.60	99.45	7.65		Nov-24
Fletcher Challenge 10.75% 15/12/97 CV (semi)		99.40	100.25	9.21		Dec-15
Fletcher Challenge 10.15% 30/11/98 CV (semi)		100.90	101.75	8.52		Nov-30
Tranz Rail Ltd. 10% 15/10/99 (semi)		102.60	103.45	8.13		Oct-15
Trans Tasman 9% 27/6/99 CV (semi)		101.00	101.85	7.99		Dec-26
St. Luke 8.7% 1/4/99 (semi) CV @ 1.00 p/sh		150.80	-	-		Oct-01
Kiwi Income Prop. Trust 9% 30/9/03 CV (semi)		124.10	126.10	7.89		Sep-30
ARGENTINEAN PESO DENOMINATED BONDS	PAR VALUE			IRR		
Bocon Pre 1: 1/4/2001	124.091	114.30	116.05	7.81		Oct-01-97
U.S. DOLLAR DENOMINATED FIXED CONV. BONDS						
Coeur D'Alene 6% 10/6/02 CV@ 26.00 p/sh		84.25	-	-		Jun-10
JumboSports 4 1/4% (semi) 1/11/00 CV @ 25.5 p/sh		66.25	-	-		Nov-01
The Learning Co. 5 1/2% (semi) 1/11/00 CV @ $53.00 p/sh		89.25	90.75	9.00		Nov-01
Novacare Inc. 5.5% (semi) 15/1/00 CV @ $26.65 p/sh		94.75	96.25	7.30		Jan-15
Beverly Enterpr. 7 5/8% (semi) 15/3/03 CV @ $20.47 p/sh		101.25	102.75	7.01		Mar-15
U.S. DOLLAR DENOMINATED FIXED RATE BONDS						
U.S. Treasury 6.25% (semi) 28/2/02		100.95	101.25	5.92		Feb-28
U.S. Treasury 6.375% (semi) 15/8/27		100.05	100.65	6.33		Feb-15
Queensland Tres. (Gold Bull) 2% 4/3/98		94.40	94.90	-		Mar-04
World Bank 7 1/8% 27/9/99 (semi) RRSP eligible		102.20	103.05	5.49		Sep-27
Mobile Telecomm 13.5% (semi) 15/12/02		114.00	114.85	9.78		Dec-15
U.S. DOLLAR DENOMINATED FLOATING RATE NOTES						
Canada Gov't 10/2/99 3 mo. LIBOR - 1/4 (qtly), callable @ 100 RRSP eligible		99.66	99.96	-	5.50	Nov-13
Bocon 1/4/01 (30 day LIBOR) starts paying May 1,'97	PAR: 119.0063	115.95	-	-		Oct-01-97
Argentina: Series L:FRB 31/3/05, 6 mo. LIBOR+13/16 (semi)	PAR: 97	94.40	95.90	7.84	6.75	Sep-30
Venezuela: DCB: 18/12/07, 6 mo. LIBOR+7/8 (semi)		94.60	95.45	8.17	6.75	Dec-18

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

HOTLINE UPDATE

Tuesday, September 2, 1997:
Good afternoon for Tuesday, September 2. We have one new recommendation: Lower stops on short December copper to 101.00, good anytime, from 109.50.

Friday, September 5, 1997:
Good afternoon for Friday, September 5. We have one new recommendation: Place stops on long December T-bonds at 111.17, close only. The following is a recap of this week's recommendations:

- On Tuesday, September 2, we recommended to lower stops on short December copper to 101.00, good anytime, from 109.50.

Tuesday, September 9, 1997:
Good afternoon for Tuesday, September 9. There are no changes or new recommendations.

Friday, September 12, 1997:
Good afternoon for Friday, September 12. We have 2 new recommendations: Lower stops on December copper to 99.35, close only **or** 101.00 stop, good anytime. As per our August 14 newsletter, we are short December deutschemarks at approximately 5503, a 3% rally from the lows. We advise to place stops at .5750, good anytime.

Flash Update, Monday, September 15, 1997:
Good afternoon for Monday, September 15, 5:00 pm. This is a flash update. On August 15, we raised the strong probability that the S&P Index had seen its peak. At the time, we advised establishing short positions with stops around 951.00. A few days later, disappointed with the lack of downside progress, we advised covering the short positions and waiting for a better opportunity. Since then, all indications have continued to strengthen our convictions that indeed, August 7 marked the peak of the mother of all bull markets. Therefore, we advise that you reestablish short positions at the market, risking 956.50, basis December, good anytime.

Tuesday, September 16, 1997:
Good afternoon for Tuesday, September 16. We have one new recommendation: Raise stops on long December cocoa to 1605, close only.

Friday, September 19, 1997:
Good afternoon for Friday, September 19. The following is a recap of this week's recommendations:

- On Tuesday, September 16, via flash update, we recommended raising stops on long December cocoa to 1605, close only.

Tuesday, September 23, 1997:
Good afternoon for Tuesday, September 23. There are no changes or new recommendations.

Flash Update, Thursday, September 25, 1997:
Good afternoon for Thursday, September 25, 11:30 am. This is a flash update. Cover short December gold at the market, presently trading at 329.50.

Friday, September 26, 1997:
Good afternoon for Friday, September 26. There are no changes or new recommendations. This is a complete summary since our last market letter, dated August 3, of all liquidations of open positions and new recommendations that remain outstanding.

- On Wednesday, August 6, via flash update, we advised to cover profitable short Czech koruna positions at the market, spot, then trading at 34.80, and to liquidate long December cocoa positions at the market, then trading at 1520.
- On Tuesday, August 26, via flash update, we advised to buy December cocoa at the market, then trading at 1625.
- On Thursday, August 28, via flash update, we advised to liquidate the September deutschemark/french franc cross, traded on the FINEX, then trading at 336.55.
- On Friday, August 29, via flash update, we advised to buy December T-bonds at the market, then trading at 112.22. On Friday, September 5, we recommended to place stops on long December T-bonds at 111.17, close only.
- On Friday, September 12, we recommended to lower stops on December copper to 99.35, close only **or** 101.00 stop, good anytime. As per our August 14 newsletter, we are short December deutschemarks at approximately 5503, a 3% rally from the lows. We advised to place stops at .5750, good anytime.
- On Tuesday, September 16, we recommended to place stops on long December cocoa at 1605, close only.
- On Thursday, September 25, via flash update, we advised to cover short December gold at the market, then trading at 329.50.

Friedberg's Commodity & Currency Comments (ISSN 0229-4559) is published by Friedberg Commodity Management Inc., P.O. Box 866, Suite 250, BCE Place, 181 Bay Street, Toronto, Ontario, M5J 2T3.

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