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The re-pricing of risk...

"The global speculative orgy is slowly coming apart, literally fraying at the edges." We wrote these exact words a little over six months ago ("Fraying at the edges," *Friedberg's Commodity & Currency Comments*, April 20, 1997); tragically, they are patently more evident today than they were then, when only Thailand and South Korea were experiencing gut-wrenching bear markets.

Long before the Hang Seng October dive unnerved Wall Street and the financial centers in Europe, we warned that "the fraying at the edges of the globe is the first sign that more troublesome times lie ahead." Immodestly we quote ourselves to direct your attention to the true significance of recent events. That these events could have been foreseen in the calmer spring days is testimony to the true financial and economic malaise that is affecting the globe.

The Southeast Asian crisis is not an accident, but the product of a cancerous disease that is spreading with alarming speed and threatens to engulf — to one degree or another and in one form or another — emerging and developing countries alike. Official reassurances that all is well come thick and fast. Respectable analysts and economists pronounce that the fundamentals of this or that economy remain bright, that exports to Southeast Asia represent only a minuscule portion of total exports and that therefore GNP in the US and other developed economies will be shaved by only 1/4% or at most 1/2%, that — unlike some multinationals — domestic companies will continue to prosper, and so on. These are but another demonstration that the patient has not been properly diagnosed.

The world economy, through permissive central banking, has been fed for a long time steady and excessive doses of cheap money. As is always the case, the initial effect was pleasurable: Insolvent financial institutions were bailed out, financial assets rose in price, good feelings spread, and politicians and the media sang the praises of capitalism. With time, successes bred further successes. Emerging/developing economies, which putatively adopted free-market policies, began to experience substantial speculative inflows, lulled by the siren song of global diversification. Investors could do no wrong: Fear began to disappear from their vocabulary.

Unbeknownst to them (shouldn't they have known?), these funds — after being skimmed by politicians, cronies of the rulers and those in the seat of power — inflated domestic credit, going mostly to the borrowers with the most clout. The damage had been done; the fatal virus had entered the body, and there

was no way to extricate it except through painful surgery.

And so it was that central banks around the world caused caution to be thrown to the wind, promoted irrational exuberance, financed wasteful projects and excessive consumption, and — when occasionally the market appeared ready to teach the fearless a lesson or two — they rode to the rescue, solemnly pledging "conditional help," unaware (or, unwilling to be aware) of the continuing moral hazard they were creating.

The spreading Southeast Asian crisis is not about slight or large declines in exports, nor about necessarily eroding profit margins of multinationals competing with Asian producers, nor even about deflation, as some observers have suggested. It is about fear and about liquidity, or rather, the evaporation of liquidity (see last month's issue). It is about re-pricing risk globally and ubiquitously. It is about what will happen to borrowers when credit will be granted only at some astronomic price that will ensure their ruin or, equally bad, when it dries up at any price.

In this issue

3 **Stock Indexes**
...leads to a bear market

5 **Japan**
A Keynesian backwater

6 **Gold**
Stand aside for now

7 **Interest Rate Futures**
Flattening yield curve

8 **Hong Kong**
Barking up the wrong tree

8 **Copper**
Bearish as ever

9 **Soft Commodities**
Soy complex, sugar

12 **Hotline Update**

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

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

Note: The next issue will appear in early December. Keep in mind that *Friedberg's Commodity & Currency Comments* does not appear every month. However, annual subscribers will still receive 11 issues in total.

The lethal and rippling effect that fear and the accompanying withdrawal of liquidity can have is best appreciated by dissecting the case of a major borrower. Take Brazil. Coming into the Asian crisis, its prospects looked, to most observers, stable. Admittedly, the deficit on current account had widened to about \$30 billion for the year. Nevertheless, the Brazilian central bank was expected to add \$4 billion to its \$60 billion of international reserves by the end of 1999. How? Through the massive privatization program contemplated for this year (which has already raised over \$17 billion) and the next two years (estimated to bring in \$40 billion), plus foreign direct investments and portfolio investments, and the assumption that trade lines, leasing, and factoring remained almost unchanged from last year's \$17 billion. At the same time, despite ongoing fiscal deficits, privatization proceeds were going to reduce net debt by almost 4% of GDP, to 28.9% from 32.7% in 1997.

Castles built on air. Privatizations and portfolio investments depend crucially on stock market behavior and sentiment. With the stock market in Brazil down more than 34% from the July peak, privatizations will become more difficult, if not impossible, to carry out, and portfolio investments will turn — if they have not done so already — into outflows. For each of the next two years, these two items alone can represent failures to receive and/or outflows of anywhere between \$20 and \$50 billion.

Now consider that Brazil needs to amortize \$20 billion of bank-issued Eurobonds and to roll over short-term foreign debt of between \$40 and \$60 billion annually on top of a current account deficit of \$30 billion, and pretty soon the central bank reserves are insufficient to meet the run. To

make matters worse, Brazil's domestic public debt, equivalent to \$180 billion, is extremely short, with an average maturity of just 7 months.

The central bank's attempt in recent days to prop up the currency had the effect of hoisting interest rates to over 36% per annum from under 15% as recently as July. An increase of 20 percentage points on this debt represents the not inconsiderable sum of \$36 billion, or 4.5% of GDP, tearing to shreds the remains of the plano real. Voilà. For Brazil, the difference between global liquidity and illiquidity is the difference between life and death, between solvency and bankruptcy.

The market has begun to perceive this problem, and in its time-honored fashion, it has begun to discount it. The market will not wait to see if the 1998 privatization program will succeed. It has been infected by fear. In much the same way as the '30s witnessed systemic bank runs, we are about to witness systemic country runs. None of these emerging country borrowers is solid enough to withstand a drying up of liquidity. Brazil is not. Neither is Russia. Nor the Eastern European countries. Nor even Greece, Turkey, or South Africa.

Still, the question is not whether the North American and European economies will be able to withstand the fall in exports to the developing world. That, they probably will. The question is how fear will affect their own economies. The answer is remarkably simple: The fear-induced re-pricing of risk will adjust, i.e., lower, asset prices, which, in turn, will affect net worth, which in turn will affect consumption, and which in turn will affect corporate profitability and investments. The net effect: A global recession of indeterminate depth and duration.

Chart 1 — JP Morgan Emerging Markets



Chart 2 — Brazil Bovespa Stock Index

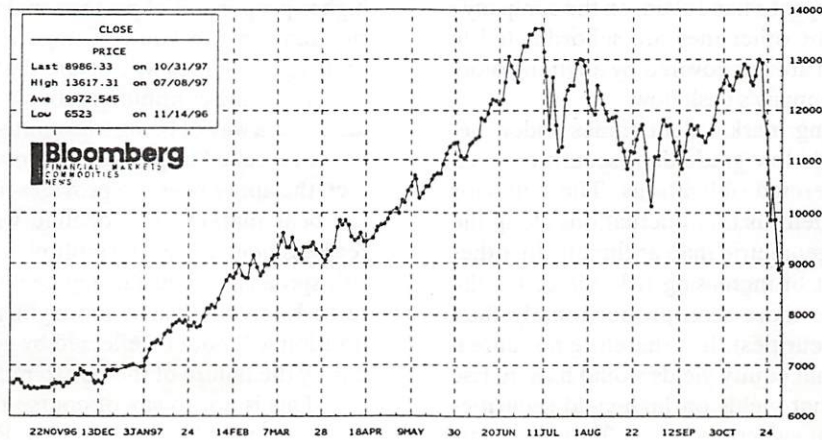


Chart 3 — Thai Stock Exchange



STOCK INDEXES

...leads to a bear market

With some hesitation, we advised in our September 28 issue to sell short stock index futures, suggesting that perhaps a top had been seen. We have since grown more certain. Not because the market has declined so dramatically but because of the complacency that has greeted this decline.

One hears that "cool" retail investors have added to their holdings, that mutual funds outflows have been moderate, pulling out only \$1.3 billion for the week ending October 29, according to AMG Data Service of Arcata Services California. One hears that professional managers have switched from companies likely to be affected by the Southeast Asian turmoil to companies with no exposure to that area — a petty and parochial view of the world as we discussed in our opening remarks.

One notes that the 10 largest equity mutual funds in the US declined by approximately the same percentage as the senior indexes, indicating that they are operating without any cash reserves. One sees prominent bull market analysts on TV and in print, unrepentant of their position and confident

that new highs will be seen. One does *not* see bears calling for further dramatic declines of the order of 25% to 50% — at least not in the media (have they all gone broke?).

We hear recited, ad nauseam, that the US economy is fundamentally sound, that stock prices cannot go down without interest rates going up first, that the present decline is salutary because it will stay the Fed's hand from raising interest rates. One notes flattering comparisons with the October 1987 market. While it is true that interest rates and inflation are much lower today than they were then, it is also true that stock prices are 290% higher and that, in fact, the market has taken enormous comfort and then some from these comparisons.

The continuing re-pricing of risk must by necessity bring about a reassessment of equity multiples. Rational markets will accord the lowest yields to the sovereign debt of industrial countries and the highest yield to equity securities, after allowing for growth in earnings. In between we find low-grade debt securities. These low-grade debt securities, euphemistically

called "high-yield" securities, are a hybrid of debt and equity: On the one hand they represent a fixed claim on the company's earnings and assets; on the other they are subordinated to senior debt and very often are not covered by anything more than the growth of the company's cash flow.

Interestingly, emerging market debt trades wider, i.e. yields more, than domestic low grade debt securities, even though it represents sovereign obligations. The behavior of emerging market debt tells us that fluctuations along the risk continuum are more geometric than arithmetic (in other words, in an environment of increasing risk, yields for the riskier securities will rise more than proportionally than yields for the less risky securities). It is therefore not unreasonable at all to assume that equity yields would have to rise by at least the amount that yields on high-yield securities have risen this week — anywhere between 25 basis points (higher-quality junk bonds) and 191 basis points (JP Morgan Emerging Market Bond Index).

For the week, however, the earnings yield of the S&P 500 index rose to 4.43% from 4.31% the prior week. Translating the expected rise in yields into price-earnings ratios generates expected multiples of 21.92x and 16.07x for the S&P 500. Applying these multiples to June fourth-quarters earnings generates fair values of between 889 and 652 compared with the 914 close. Either the high-yield debt market has overreacted or the US stock market has become even more

overvalued. We strongly suspect the latter given the much higher proportion of professional traders in the debt categories than in the equity categories. At the very least, risk arbitrage activities will ensure that these spreads will close.

Thus, the continuing process of re-pricing risk in distant lands has a way of being transmitted to Wall Street, regardless of the so-called bright fundamentals for the US economy. In fact, the above exercise provides us with a valuable insight to the bear market: The decline will be led by a downward reassessment of earning multiples resulting from increases in risk spreads, not by earning declines nor by rises in interest rates. Keep this insight about you at all times, and your short position will not be deflected by good earnings performance nor by the failure of the Fed to raise interest rates.

This is not to say of course that economic cycles have been eliminated. They have not. Rather, the decline in earnings, when it comes, will be the result of cyclical forces, and these cyclical forces will be triggered — uniquely for the past 60 years — by a re-pricing of risk.

It is a bear market, alright.

STRATEGY: We advised going short in our September 28 issue, indicating that we were doing so with great trepidation. We are no longer hesitant. Add to your position by selling December '97 Dow Jones futures. Lower stops to 8185, basis the Dow Jones Cash Index, good anytime.

Chart 4 — Dow Jones Indus. Avg.



Chart 5

J.P. MORGAN EMERGING MARKETS BOND INDEX

This table shows the index level and total return of bonds issued by the listed nations and denominated U.S. dollars. The ultimate principal payments on some of these securities, commonly called "Brady bonds," are backed by U.S. Treasury bonds. The interest payments are the obligations of the individual countries and are backed by high-grade securities as collateral in some cases. In the indexes, 100=December 1990 except where noted.

	Total Return (%)			
	Index	Week	YTD	12 Mos.
EMBI	318.04	-8.92	6.77	14.00
Latin only	310.57	-8.81	6.47	13.54
Non-Latin	303.57	-10.08	10.96	19.92
Argentina (4/93)	200.45	-6.99	9.86	18.32
Brazil	367.65	-12.57	1.72	7.56
Bulgaria (11/94)	226.09	-14.79	36.90	61.40
Ecuador (6/95)	201.74	-12.78	7.16	15.86
Mexico	285.39	-2.60	14.52	20.85
Nigeria (1/92)	316.45	-10.25	1.10	13.06
Panama (3/97)	94.20	-10.21
Peru (5/97)	89.48	-14.15
Poland (11/94)	175.71	-5.02	1.13	4.39
Venezuela	314.46	-4.06	9.67	19.34
Fixed-rate	370.93	-7.84	10.15	18.27
Floating-rate	273.55	-9.79	3.96	10.52

Source: J.P. Morgan

JAPAN

A Keynesian backwater

Steve H. Hanke

The first and foremost critic of John Maynard Keynes was Nobel economics laureate Friedrich von Hayek, the great leader of the Austrian School of Economics. Even though Keynes and Hayek were, in Hayek's words "personally very great friends," these two giants clashed over economics. At the most fundamental level, Hayek was opposed to the notion of macroeconomics and, of course, the particular brand that Keynes was peddling. For Hayek, the entire foundation of macroeconomics, with the use of aggregates and averages, was wrong-headed. The notions of aggregate demand and supply were simply nonsense. And, in consequence, Keynesianism — the government's use of fiscal and monetary policy to manage or balance aggregate demand and supply — was fatally flawed. The Austrians, in my opinion, correctly concluded that the corpus of economics was limited microeconomics.

Unfortunately, after Keynes published the *General Theory* in 1936, there was a "Keynesian Revolution." Consequently, from 1936 through the 1960s, the majority of professional economists, and virtually all of the prominent economists were Keynesian. And what is worse, most governments embraced Keynesian policies to manage their economies. The counter-revolution began in the 1970s, when the world was in the grip of stagflation. It was then that Nobel laureate Robert Lucas and his colleagues at the University of Chicago started to produce the new classical economics that overthrew Keynesian theory. In consequence, by the 1980s, many governments started to play down Keynesian economics.

Japan has remained a backwater, however. Keynes still reigns supreme in Japan. In an attempt to keep their economy afloat in the wake of the fallout from the collapse of the "bubble economy" in 1990, the Japanese attempted to restimulate the economy with a massive public works program, the ultimate Keynesian medicine. Since 1992, the Japanese have recycled \$600 billion of valuable private savings into worthless public projects. This Keynesian experiment has been a bust. But why?

Because of trade-war threats from the US, Japan pursued a strong yen policy from 1971. Indeed, until April 1995, this was a super-strong yen policy. It was accepted by the Japanese, particularly in the early 1990s, because it was viewed as a way to keep the stock market propped up and therefore to stave off a complete collapse of the country's banking system. All this put in motion the massive forces of deflation, which included super-high real interest rates. By April 1995, when the yen hit 80 to the greenback, it was clear that things were going terribly wrong. Since then, the yen has depreciated to about 120 to the dollar. But this still leaves the

yen grossly overvalued, with its purchasing power parity at around 150 to the dollar.

It also leaves the forces of deflation in place. Alas, the Japanese authorities remain trapped in the Keynesian paradigm. Indeed, the rapid rise in narrow money measures relative to broad money is a classic symptom of a liquidity trap, where a rapid rise in the money supply does not bring about an increase in the demand for goods but simply reflects the public's increased demand for money balances in a deflationary environment. In short, the public is worried about the state of the economy and the banking system and wants to hold cash, which has a positive yield during a deflation.

What's next? Eisuki Sakakibara, "Mr. Yen," and US Secretary of Treasury Rubin would like to see the yen remain overvalued at 120-125 to the dollar. This means more deflation and the continuation of the liquidity trap. Alas, at this exchange rate, the economy will continue to sink. Hopefully, the authorities in Tokyo and Washington will soon realize that the yen must be allowed to depreciate relative to the greenback and move towards its purchasing power parity. But that will solve only part of Japan's problems.

Japan must also allow "someone" to take a hit on the "bubble economy" losses that have already taken place, but still haven't been booked and realized. This will require the Ministry of Finance officials to stop their ad hoc policy moves intended to protect the desperately weak financial sector. But, until this happens, these losses will remain a dark cloud over the economy, one that continues to motivate the Japanese public to demand cash and keeps the liquidity trap in place.

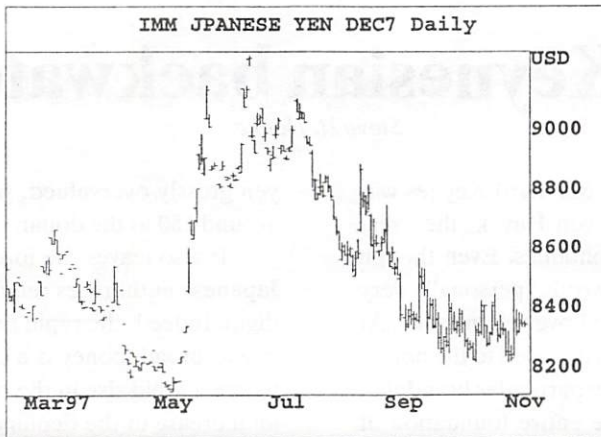
Lastly, the Japanese must push ahead with a massive deregulation of the economy, one based on a sound microeconomic foundation. This is required, so that Japanese companies can start to downsize, something that American companies started to do 10 years ago and something European companies have started to do recently. No gain without some pain.

Thanks to the embrace of the Keynesian economics, Japan is in big trouble. The road to recovery is clear enough. The Japanese must drop Keynes, and fast. What isn't clear is whether the Hashimoto government has the political will and capacity to dump Keynesian economics once and for all.

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STRATEGY: Continue to sell short-term at-the-money yen call options.

Chart 6 — Japanese Yen



GOLD

Stand aside for now

News that a government committee in Switzerland proposed selling as much as 1,400 tonnes of gold, more than half of the country's reserves, triggered massive liquidation. Bullion prices fell over \$16/oz. to 12-year lows. In subsequent days the decline was attenuated by weakness in global stock markets, tension in Iraq, and a Swiss government announcement that it had endorsed a plan to sell 800 tonnes instead of the committee's 1,400-tonne recommendation.

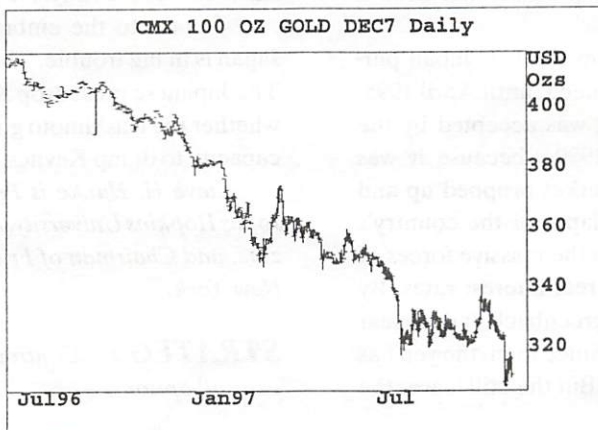
In coming months and years, mine closures will have to take place to make room for increased central bank disposals. According to analysts at ABN Amro Chicago Corp., of 101 mines now operated by North American gold producers, 10% have cash costs, excluding depreciation and interests, that will top \$300/oz. this year through 1999. At \$275/oz. as many as 20% of mines owned by North American producers would be in jeopardy of closing. The situation in South Africa is even more dramatic. According to a precious metals analyst at Huysamer Stals Pty. Ltd., in Johannesburg, South African gold production would drop by around 15% to 20% if gold prices stayed at present levels. Finally, Peter Richardson, head of Commodity Research at SBC Warburg in London, said that 25% of the

world's gold producers would be losing money at a gold price as high as \$335/oz. None of these cutbacks, however, have as yet occurred. Cutbacks in mine production of 20% to 25% could accommodate an orderly disposal — and over a number of years — of most central bank bullion holdings.

Rallies in this market have been preceded by a substantial build-up in speculative short positions, while declines have proceeded with a book generally light of speculative short sales. The recent decline to \$307.50/oz. followed the script to perfection. At the lows, a new buildup of speculative short sales was in the making. More disturbing (to the bears), however, is the persistently high level of lease rates, which has stayed above 3% per annum for most of the past few weeks. We suppose that it represents heavy producer hedge activities. We are at a loss, however, to understand the relative tightness of supply. Whatever may be the explanation, the market may be heavily oversold at these levels. If this technical condition persists, we can envision a substantial rally triggered perhaps by further stock market declines.

STRATEGY: *Stand aside.*

Chart 7 — Gold



INTEREST RATE FUTURES

Flattening yield curve

STRATEGY: The yield curve continues to flatten, a strong positive for our long T-bond position. Raise stops to 116.13, close only.

Chart 8 — Multiple Historic Curves

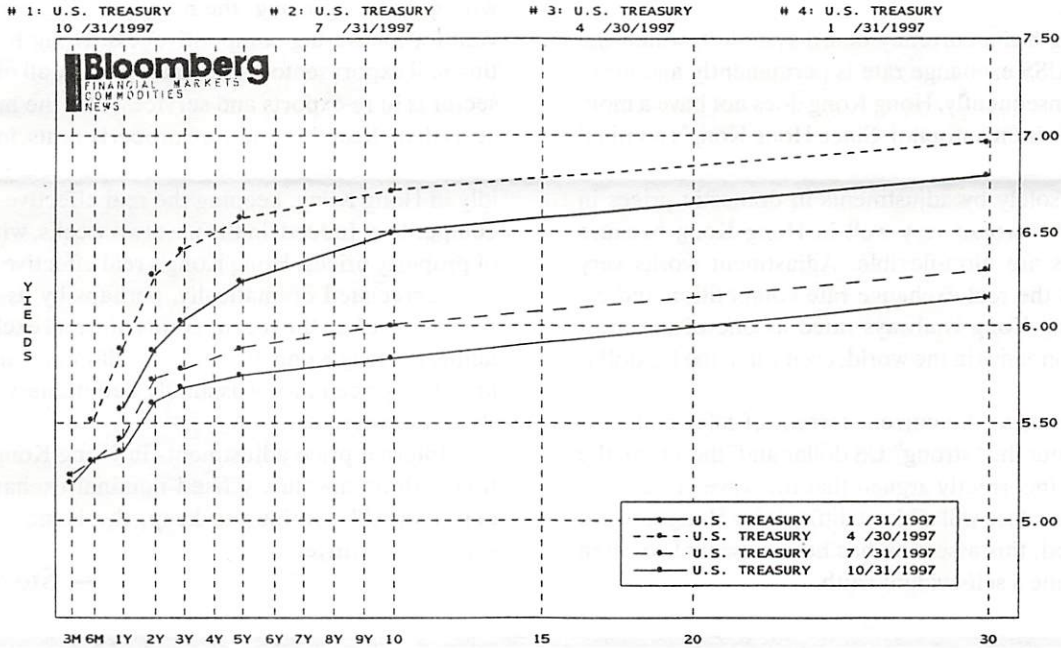
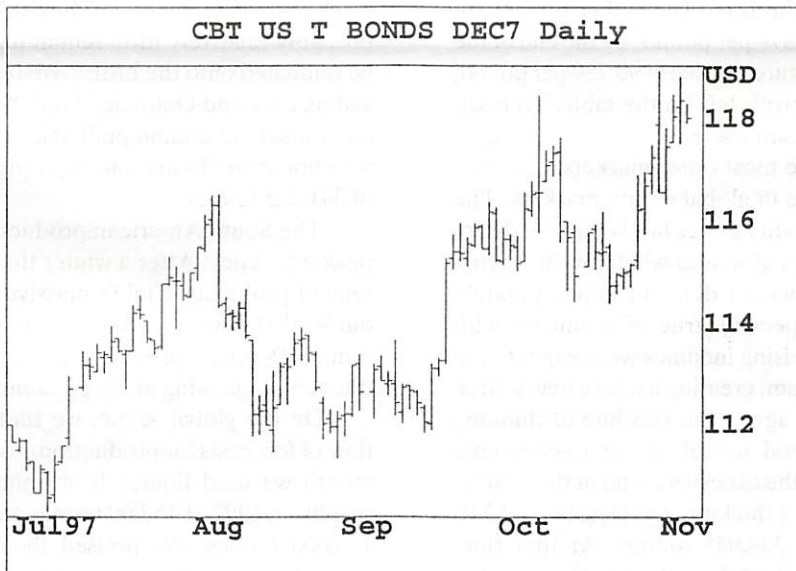


Chart 9 — US T-Bonds



HONG KONG**Barking up the wrong tree***By Steve H. Hanke*

Journalists and the economists they talk to have a habit of barking up the wrong tree, particularly during times of crisis. The recent dust-up over the Hong Kong dollar illustrates this point in spades.

Hong Kong has a currency board system in which the nominal HK\$/US\$ exchange rate is permanently and absolutely fixed. Consequently, Hong Kong does not have a monetary policy — it is on autopilot. Since Hong Kong's nominal exchange rate is fixed, real exchange rate adjustments are brought about solely by adjustments in domestic prices in Hong Kong. This works very well in Hong Kong because domestic prices are ultra-flexible. Adjustment works very rapidly to keep the real exchange rate competitive and explains why Hong Kong is always rated as one of the most competitive economies in the world, even when the US dollar is "strong."

This brings us to the current torrent of false concerns being raised about the "strong" US dollar and, therefore, the HK dollar. It is incorrectly argued that the wave of devaluations in Southeast Asia will make it difficult for Hong Kong to compete. Indeed, this assertion has been repeated so often that it has become a self-evident truth.

Lacking a well-grounded understanding of true fixed nominal exchange rates and knowledge of the Hong Kong economy and its workings, the commentators have it all wrong. In Hong Kong, the nominal exchange rate is irrelevant for measuring competitiveness. Hong Kong has only a tiny real export sector in goods. Virtually all of its huge trade sector is in re-exports and services, and the most significant costs that affect this trade are property rents, followed by unit labor costs. Both of these cost components adjust very rapidly in Hong Kong, keeping the real effective exchange rate competitive. Indeed, in the past two weeks, with the collapse of property prices, Hong Kong's real effective exchange rate has depreciated dramatically, perhaps by as much as 20%. And even before the recent events, the real exchange rate was falling in Hong Kong, because the all-important and relevant producer price index was mildly deflationary, declining at a -0.5% annual rate.

Internal price adjustments in Hong Kong, in combination with an absolutely fixed nominal exchange rate, have kept and will continue to keep, the Hong Kong economy super-competitive.

— **Steve H. Hanke**

COPPER**Bearish as ever**

On Monday, October 20 we recommended the covering of short copper positions. At the time, December copper futures were trading just below 97¢ per pound. By the end of the following week, December futures settled at 90.75¢ per pound, 6.4% lower — a handsome profit left on the table. To boot, we think we pulled off a brilliant trade.

The copper market, like most other markets, has been trading off the recent plunge in global equity markets. The theory with regard to commodity prices holds that the disappearance of billions of dollars of wealth will limit the buying power of consumers, dampening demand and ultimately prices. This would hold especially true of countries with emerging economies where rising incomes were expected to trickle back through the system, creating a whole new source of demand. Not only do we agree, but this line of thinking also fits well into our general model of macro-economic fundamentals with regard to the excesses found in the system.

Actually, the bearish plot thickens. On October 9, LME warehouse stocks stood at 338,925 tonnes. At that time Bloomsbury Mineral Economics released a report suggesting

that the unprecedented, 4-month, close-to-300% rise in these stocks would soon abate. They state in the report: "There is probably relatively little remaining copper inventory still to be relocated onto the LME... We believe that LME stocks will stabilize by end-October." Well, "end-October" has arrived, and outside of a lame pullback that lasted all of a few days, warehouse stocks are hanging tough at yet another new high of 341,225 tonnes.

The South American production machine is cruising at peak efficiency. After a winter that was plagued by weather-related problems, Chile's massive Escondida mine cranked out 91,000 tonnes of copper, up 39% from August's 65,000 tonnes. Peruvian production, based on the first 6 months of this year, is growing at 5% per annum.

On the global scene, we find support in a continuous flow of forecasts for production/consumption surpluses. Last month we used figures from miner Asarco that showed a surplus in 1997 of 15,000 tonnes and still a deficit for 1998 of 173,000 tonnes. We praised their not-in-their-best-interest upward revision of production and downward revision of

consumption. Still, Asarco is an industry player, so we found the report by unattached commodity brokers GNI, released on October 31, intriguing. It estimates that 1996 had a 339,000 tonne surplus, and calls for a 209,000 tonne surplus this year and a 470,000 tonne surplus in 1998, "...with more to follow in 1999."(!) The net effect will be a move from a 5% stocks-to-consumption ratio in 1996 to a 10% stocks-to-use ratio in 1998.

So what was so brilliant about leaving profits behind? This market has shown classical signs of being oversold. The drop of the past week can be traced solely to the action in the stock market. We did not need to see the vulnerability that exists in the equity markets to make the connection between the demand that will be lost due to inflated economies and the price of copper. This week's market gyrations did not cause weakness in commodity prices. Those that were weak were already weak; those that were strong on their own fundamentals remained strong. As soon as the stock market

regains some stability, even if it is moving down, the fundamentals and technicals of each commodity market will take over.

In the case of copper, open interest has swelled, both in New York and on the LME, to levels not seen in a very long time. Sentiment indicators show that about 80% of participants have been bearish since late August. Together, these two factors suggest to us that whatever selling power exists, it has already been exercised for the moment.

As illustrated, we are as bearish as ever. The price at which we re-enter this market is not as important as the confidence we have in the total picture, which includes not only fundamentals but the select group of technical indicators that we find supportive of our trading style.

STRATEGY: *We await an opportunity to re-enter the short side of the market.*

— Sholom Sanik

SOFT COMMODITIES

Soy complex

Considering all that is being touted as being bearish about the soy complex, we think the beans are putting in a stellar performance. The most prominent, of course, is the headline-grabbing factor, the turmoil in the financial markets, which should be limiting the buying power of the best customers of US beans and their products. It has begun to manifest itself, at least on the surface, in cancelled contracts. Analysts expected so many cancellations this past week that the weekly estimates issued Wednesday afternoon for the following morning's USDA export commitment data had a ludicrously wide range of 50,000 to 500,000 tonnes for soybeans. As it is, even with a fair amount of cancellations, the commitments came in close to the high end at 438,000 tonnes.

The harvest is running smoothly. By October 24, 85% of the soybean crop had been collected vs. 72% last year at this time, and a 77% 5-year average.

In the October 10 USDA supply/demand situation report, we find the anticipated record crop to be on track. However, a subtle change here and there means that we cannot call the curtains on the bull market. The average trade estimate called for a production increase of 26 million bushels. Instead the USDA lowered production by 50 million bushels. A small but expected increase in exports of 10 million bushels may not seem like much, but puts 1997-98 exports at a record high 960 million bushels. Even after accounting for an increase in 1996-97 ending stocks of 17 million bushels, ending stocks for 1997-98 will drop down to 270 million bushels from last month's 285 million bushels and 305 million bushels of the August report.

The most exciting statistics, though, come from where we've put our money, soybean oil. In the October 10 report

the USDA estimated that 1996-97 ending stocks were 1.55 billion pounds. This would be down 23% from the year earlier and represents a 9.5% stocks-to-consumption ratio vs. 14% a year earlier.

Then on October 16, the National Oilseed Processors Association (NOPA) reported that oil stocks at the end of September were in fact only 1.191 billion lbs., indicating that the USDA was simply way off. Deducting the appropriate amount from this coming season's ending stocks would leave us with a carryout of 1.191 billion pounds, same as last year, but with a larger consumption, representing only a 7% stocks-to-consumption ratio.

A recent article in *Forbes* magazine satirizing the El Niño scare was entitled "El Hyp-o," indicating that much of the market's movements based on El Niño were no more than overreactions to media hype. In some of the palm-oil-growing regions of Indonesia, the second largest producer of palm oil behind Malaysia, rains are now more than a month overdue. The current palm fruit from which the oil is crushed is not affected, but crops just starting to grow now will be affected down the road.

The one disquieting factor about this position is the company we keep. The open interest is very high. Back in early 1995, when the market toyed with the 30¢ level, the open interest was about 10,000 contracts higher, so this level is not unprecedented, but is still quite burdensome.

More disturbing, though, is that the commercials are short this market, and funds and small speculators are long. Nevertheless, we choose, for the moment, to be contrarian, even with these somewhat ugly technical factors looming in the background, as they are the favorite topic du

jour of the scribes of the daily news-wire reports. With the bad news being public knowledge, it probably has been discounted. The demand side fundamentals are strong; corrections will probably be met with stiff resistance from commercials. The prices are still cheap compared with historical levels and certainly against \$7.00 beans.

STRATEGY: Remain long December '97 soybean oil, first recommended in the Hotline on October 13. Place stops at 23.95, close only.

Sugar

First, a brief history. The last time we discussed the sugar market was in the July 1995 issue. Since being taken out of the market on our 10.30¢/lb. sell stop, way back then, we've let this market be. Just as well, as sugar prices have drifted in a narrow range between 10¢ and 12¢ ever since, a perfect recipe for getting stopped in and out many times, serving only to rack up a trophy shelf of small losses. At that time, spot prices were commanding huge premiums over future prices, at times of over a penny per pound. We believed that the market could not possibly facilitate the demand represented in such a steep backwardation and not head back to the price levels achieved earlier that year in the 15¢/lb. range. We brushed aside the argument that the inversion was being caused by port disruptions in Brazil and other temporary factors. We were right and wrong.

We were wrong because global production was swelling and was going to create burdensome stockpiles. The early part of the decade saw production decline as prices were declining. Then the first half of 1993 caught the market off guard as the decline in production saw supplies not fulfilling the demand that did not decline together with production. We rode the market up to 16¢, but then the market responded with a jump in production from 110,000 in 1993-94 to 116,000 tonnes in 1994-95 and then to 122,000 in 1995-96. Prices collapsed to the tight coil in which they would spend the next two years. Production stabilized the next two seasons (including forecasts for this season) at the same lofty level. The 1995-96 season left the market with a whopping 4.4 million-tonne surplus.

We were right because the demand was there; it was just being overwhelmed by growth in production. While the 1995-96 season left a huge surplus, the next year saw a deficit of 600,000 tonnes, which brings us to this season. Analysts' estimates range wildly, but it seems that there is a consensus that the production/consumption deficit could be as large as 3 million tonnes.

Production has not grown at all since the big jump in the

1995-96 season and remains steady at 122 million tonnes. Consumption, on the other hand, has grown in every year since the 1993-94 season and is expected to register a tally of 125 million tonnes. Now that the huge surplus left at the end of the 1995-96 season has been eaten into, the rules have changed.

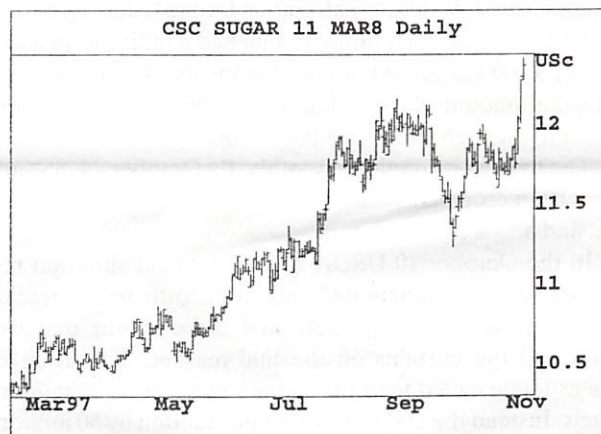
Typically we analyze a commodity's fundamentals and then look to the few technical indicators, usually proprietary, that we find reliable for support, and a trade is born. Having said that, a confession is in order, in that things happened the other way around in this case. We were alerted to the potential breakout in this market by a study of the implied volatility of its options.

Historically, sugar has been one of the most volatile of all commodity markets as determined by the implied volatility model, which measures how cheap/expensive an option premium is. Sugar option premiums have traded as high as 35% in recent years (very high) but have recently collapsed to trade as low 16% (very low). Theory holds that when option prices are cheap, writers of options have become complacent and are willing to bet that the price of the underlying security will remain locked in the range it's been trading in. The complacency, as all complacencies, should be treated with scepticism, and thus a break of the trading range can be seen on the horizon. After gaining the knowledge that the trading range will be expanded, one still does not know on which side the two-year-long, boring market will resolve itself. That is when one scurries after the fundamentals, and as illustrated, we find they are bullish, and the trade is born.

STRATEGY: We are long March sugar at 11.70, basis March, via Flash Update. Alternatively, buy still very cheap out-of-the-money call options.

— Sholom Sanik

Chart 10



**Chart 11 — Friedberg Capital Markets
Recommended current portfolio allocations**

1. KIPT 9% cv (NZ\$)	15%	5. Trans Tasman 9% '99 (NZ\$)	5%
2. US Treas. Cpn Strips 0% '25 (US\$)	5%	6. Canada FRN '98 (US\$)	10%
3. US Treasury 6.375% '27 (US\$)	15%	7. 10-year BUNDS, hedged (US\$)	12.5%
4. US Treasury 6.25% '02 (US\$)	37.5%		

Chart 12 – FOREIGN CURRENCY BONDS

DATE: October 31, 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	104.40	105.25	4.36		Oct-13
World Bank 9% 13/11/00 RRSP eligible	111.85	-	-		Nov-13
Kingdom of Denmark 6 1/8% 15/04/98	100.30	101.15	3.51		Apr-15
Argentina 8% 5/10/98	99.90	100.75	7.08		Oct-05
Kgdm. of Spain (6 Mo. LIBOR-1/16) 29/6/02 (semi)	99.86	100.16	-	3.09375	Dec-29
CZECH REPUBLIC KORUNA BONDS					
General Electric Cap. Corp. 10.5% 23/10/98	93.50	-	-		Oct-23
Nordic Inves. Bk 10.625% 10/11/00	89.90	-	-		Nov-10
Intl. Fin. Corp 10% 30/4/98	94.05	-	-		Apr-30
SWISS FRANC DENOMINATED BONDS					
General Electric Cap. Corp. 4 3/4% 2/7/98	100.90	-	-		Jul-02
General Electric Cap. Corp. 4 1/2% 17/12/99	103.05	-	-		Dec-17
DANISH KRONE DENOMINATED BONDS					
Kgdm. of Denmark 9% 15/11/98	103.85	104.70	4.24		Nov-15
ECU DENOMINATED BONDS					
United Kingdom 9 1/8% 21/02/01	111.45	112.30	4.97		Feb-21
BRITISH POUND DENOMINATED BONDS					
European Inv. Bk. 7% 22/12/98	98.95	99.80	7.16		Dec-22
Kgdm. of Denmark FRN 28/8/98 3mo LIBOR-12.5b.p.(qly)	99.77	100.07	-	7.1875	Nov-28
JAPANESE YEN DENOMINATED BONDS					
World Bank 4 1/2% 22/12/97 (semi) RRSP eligible	99.90	100.75	N/A		Dec-22
CANADIAN DOLLAR DENOMINATED BONDS					
Eksportfinans 7 3/4% 5/11/97	99.40	100.65	N/A		Nov-05
Ontario Province 10 5/8% 15/7/98 RRSP eligible	103.55	104.80	3.44		Jul-15
Petromet Resources 6.5% 31/3/04 (semi) CV @ \$9.50 p/sh	91.50	-	-		Mar-31
SOUTH AFRICAN RAND DENOMINATED BONDS					
ESCOM 11% 1/6/08 (semi)	79.10	80.60	14.68		Dec-01
AUSTRALIAN DOLLAR DENOMINATED BONDS					
Toronto Dominion Bk. Aust. 7.25% 26/2/99 RRSP eligible	102.50	103.35	4.53		Feb-26
NEW ZEALAND DOLLAR DENOMINATED BONDS					
World Bank 8.25% 30/4/99 RRSP eligible	101.35	102.20	6.60		Apr-30
New Zealand Gov't 8% 15/7/98 (semi)	99.65	100.50	7.23		Jan-15
Ontario Province 7.15% 24/11/98 (semi)	98.20	99.05	8.10		Nov-24
Fletcher Challenge 10.75% 15/12/97 CV (semi)	99.25	100.10	9.43		Dec-15
Fletcher Challenge 10.15% 30/11/98 CV (semi)	100.55	101.40	8.74		Nov-30
Tranz Rail Ltd. 10% 15/10/99 (semi)	102.25	103.10	8.23		Apr-15
Trans Tasman 9% 27/6/99 CV (semi)	96.10	96.95	11.34		Dec-26
St. Luke 8.7% 1/4/99 (semi) CV @ 1.00 p/sh	139.95	-	-		Apr-01
Kiwi Income Prop. Trust 9% 30/9/03 CV (semi)	118.10	120.10	8.98		Mar-31
ARGENTINEAN PESO DENOMINATED BONDS					
Bocon Pre 1: 1/4/2001					
	PAR VALUE		IRR		
	121.2103	95.10	96.85	18.96	Nov-01-97
U.S. DOLLAR DENOMINATED FIXED CONV. BONDS					
Coeur D'Alene 6% 10/6/02 CV @ 26.00 p/sh	81.25	-	-		Jun-10
JumboSports 4 1/4% (semi) 1/11/00 CV @ 25.5 p/sh	65.25	-	-		Nov-01
The Learning Co. 5 1/2% (semi) 1/11/00 CV @ \$53.00 p/sh	90.75	92.25	8.49		Nov-01
Novacare Inc. 5.5% (semi) 15/1/00 CV @ \$26.65 p/sh	94.25	95.75	7.63		Jan-15
Beverly Enterpr. 7 5/8% (semi) 15/3/03 CV @ \$20.47 p/sh	100.25	101.75	7.22		Mar-15
U.S. DOLLAR DENOMINATED FIXED RATE BONDS					
U.S. Treasury 6.25% (semi) 28/2/02	101.45	101.75	5.78		Feb-28
U.S. Treasury 6.375% (semi) 15/8/27	102.95	103.55	6.11		Feb-15
U.S. Treasury Coupon Strips 0% 15/2/25	18.50	19.00	6.18		Feb-15-25
Queensland Tres. (Gold Bull) 2% 4/3/98	93.625	93.875	5.70		Mar-04
World Bank 7 1/8% 27/9/99 (semi) RRSP eligible	102.20	103.05	5.41		Mar-27
Mobile Telecomm 13.5% (semi) 15/12/02	112.25	113.10	10.15		Dec-15
U.S. DOLLAR DENOMINATED FLOATING RATE NOTES					
Canada Gov't 10/2/99 3 mo. LIBOR - 1/4 (qly), callable @ 100 RRSP eligible	99.60	99.90	-	5.50	Nov-13
Bocon 1/4/01 (30 day LIBOR) starts paying May 1,97	PAR: 116.2438	106.70	-	-	Nov-01-97
Argentina: Series L:FRB 31/3/05, 6 mo. LIBOR+13/16 (semi)	PAR: 96	82.90	84.40	11.43	Mar-31
Venezuela: DCB: 18/12/07, 6 mo. LIBOR+7/8 (semi)	85.2F	86.1C	11.05	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

Flash Update: Tuesday, September 30, 1997.

Good morning for Tuesday September 30, 8:45 am. This is a flash update. Resell December copper at the market, presently trading at 99.00.

Tuesday, September 30, 1997.

Good afternoon for Tuesday, September 30. This morning, via flash update of 8:45 am, with December copper trading at 99.00, we recommended selling copper at the market. Place stops at 101.00, good anytime.

Flash Update: Wednesday, October 1, 1997.

Good afternoon for Wednesday, October 1, 4:30 pm. This is a flash update. We have two new recommendations. Reinstate short December gold positions at the market, placing stops at 341.00, good anytime. And buy March sugar at the market, placing stops at 1132, close only.

Friday, October 3, 1997.

Good afternoon for Friday, October 3. There are no changes or new recommendations. The following is a recap of this week's recommendations.

- On Tuesday September 30, via flash update, we advised reselling December copper at the market, then trading at 99.00, placing stops at 101.00, good anytime.
- On Wednesday, October 1, via flash update, we advised reinstating December gold positions at the market, then trading at 336.00, placing stops at 341.00, good anytime AND buying March sugar at the market, then trading at 11.70, placing stops at 1132, close only.

Tuesday, October 7, 1997.

Good afternoon for Tuesday, October 7. There are no changes or new recommendations.

Friday, October 10, 1997.

Good afternoon for Friday, October 10. There are no changes or new recommendations.

Flash Update: Monday, October 13, 1997.

Good afternoon for Monday, October 13, 5:00 pm. This is a flash update. Buy December soybean oil at the market.

Flash Update: Tuesday, October 14, 1997.

Good morning for Tuesday, October 14, 9:45 am. This is a flash update. Liquidate December cocoa positions at the market, presently trading at 1660, cancelling the 1605, close only stop. We repeat the flash update of last night, to buy December soybean oil at the market, then trading at 24.80.

Friday, October 17, 1997.

Good afternoon for Friday, October 17. There are no changes or new recommendations. The following is a recap of this week's recommendations.

- On Monday, October 13, via flash update, we advised buying December soybean oil at the market, then trading at 24.80.
- On Tuesday, October 14, via flash update, we advised liquidating December cocoa positions at the market, then trading at 1660, cancelling the 1605, close only stop.

Flash Update: Monday, October 20, 1997.

Good morning for Monday, October 20. This is a flash update. Cover December copper at the market, presently trading at 9680.

Tuesday, October 21, 1997.

Good afternoon for Tuesday, October 21. There are no changes or new recommendations.

Flash Update: Wednesday, October 22, 1997.

Good afternoon for Wednesday, October 22, 4:00 pm. This is a flash update. We have two new recommendations. 1) Sell December deutschemarks at the market, placing initial stops at 5800, good anytime. 2) Raise stops on long December T-bonds to 114.20, good anytime from 111.17, close only.

Friday, October 24, 1997.

Good afternoon for Friday, October 24. There are no changes or new recommendations. The following is a recap of this week's recommendations.

- On Monday, October 20 via flash update, we advised covering December copper at the market, then trading at 9680.
- On Wednesday, October 22, via flash update, we advised selling December deutschemarks at the market, placing initial stops at 5800, good anytime, AND to raise stops on long December T-bonds to 114.20, good anytime from 111.17, close only.

Tuesday, October 28, 1997.

Good afternoon for Tuesday, October 28. There are no changes or new recommendations.

Flash Update: Thursday, October 30, 1997.

Good afternoon for Thursday, October 30, 12:45 pm. This is a flash update. Cover short December gold positions at the market, presently trading at 319.00.

Friday, November 1, 1997.

Good afternoon for Friday, October 31. There are no changes or new recommendations. This is a complete summary since our last market letter dated September 28, of all liquidations of open positions and new recommendations that remain outstanding.

- On Wednesday, October 1, via flash update, we advised buying March sugar at the market, then trading at 11.70, placing stops at 1132, close only.
- On Monday, October 13, via flash update, we advised buying December soybean oil at the market, then trading at 24.80.
- On Tuesday, October 14, via flash update, we advised liquidating December cocoa positions at the market, then trading at 1660, cancelling the 1605, close only stop.
- On Wednesday, October 22, via flash update, we advised raising stops on long December T-bonds to 114.20, good anytime from 111.17, close only.
- On Thursday, October 30, via flash update, we advised covering short December gold positions at the market, then trading at 319.00. We would like to remind you that clients are short S&P futures as per the September 28 newsletter, with stops at 8299, basis the Dow Jones Industrial Index. We advise remaining short.

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