

# FRIEDBERG'S

## COMMODITY & CURRENCY COMMENTS

Friedberg Commodity Management Inc.



Volume 19, No. 1 January 11, 1998

## 1998: Annus mirabilis? Some unpleasant thoughts in the new year

As the world enters its second financial convulsion in less than three months, one senses that events are about to overtake men. Fears have gripped some markets, and they just won't let up. Like falling dominoes, one country's or one region's problems have begun to infect other ones, sometimes via deteriorating terms of trade, sometimes via falls in export volumes caused by the lack of trade finance, sometimes via currency falls in a particularly tight currency bloc. And in hundreds of other unsuspecting ways. A feeling of unease, an amorphous fear, has spread far and wide.

Politicians and policy makers cannot seem to find a way to restore calm. Worse yet, they have as yet not begun to understand the roots of our present-day predicament. This ignorance has led to a tragic series of policy errors that have compounded the crises. At the very heart of the problem lies the putatively gratuitous expansion of credit — in the pursuit of economic growth — engineered by the most important monetary engine in the world: the US Federal Reserve Bank.

The easy money policy of the past decade was directly responsible for the explosion of domestic consumer debt and for rampant securities (and now real estate) speculation. It also provided the wherewithal for the highly speculative and highly questionable loans extended to, and investments made in, emerging economies.

Perhaps Milton Friedman (whom we engaged in these pages last summer) may have been right in urging the Fed to stay its course if US stocks had been an *isolated* case of excessive speculation. But this was clearly not so, as any sophisticated observer of emerging market debt spreads could have noticed (for a fascinating but absolutely common-sense analysis of the astounding shrinkage of these spreads before last October and their implication, see "Spreads and Risk in Emerging Markets Lending," William R. Cline and Kevin J.S. Barnes, *IIF Research Papers*, No. 97-1, Institute of International Finance, November 1997). Also noticeably speculative were real estate lending, financed by dollar inflows in Southeast Asia, and other asset-price inflation in more than a dozen other countries built — not coincidentally — on rising international reserves.

During the course of this decade, the global balance sheet became progressively more vulnerable: The counterpart of this gigantic debt inflation was asset inflation. Returns on real assets and yields on securities began to fall. They soon converged with, and then fell below, interest costs. As risks

premiums soared, returns on assets became even more negative. Creditors have now begun to call in their loans; the great debt inflation of the past decade has come to a grinding halt in a good part of the globe, and the painful process of debt deflation, or liquidation, has set in.

This needs to be understood. Easy money (remember easy-come, easy-go?) causes debt inflation, which in turn causes asset inflation. When the latter meets the cold logic of return, credit is called in and debt deflation begins. The corollary is rather simple: New doses of easy money can only postpone the day of reckoning, not solve the problem. As the Fed ponders its next move, it should remember that today's bubbles were of its own doing, particularly the easing moves that followed the Crash of 1987 and the recession of 1991, when the US banking system tottered on the brink of insolvency.

The reckless expansion of central bank credit, by itself, may not have threatened the developed world's *banking* system

### In this issue

- 3 Russia**  
Russia's rickety ruble
- 5 Stock Market**  
The beginning of the end
- 6 Interest Rates**  
Playing deflation
- 7 Japanese Yen**  
On the brink of collapse
- 7 Gold**  
The trend is your friend
- 7 Silver**  
Conspiracy theories
- 8 Copper**  
The perfect bear
- 9 Soft Commodities**  
Cocoa, soy complex
- 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.

were it not for the fact that these banks were bailed out in the past — under the “reasonable” pretext of avoiding a systemic run. The Crash of 1987, the S&L crisis of the early '90s, and Mexico in 1994 engendered the now famous problem of “moral hazard,” reassuring commercial and investment banks that under no circumstances would they be allowed to fail.

In a heads-I-win-tails-you-lose frame of mind, these financial institutions engaged in highly risky lending, sure in their belief that they would not suffer meaningful losses. Soon after the IMF-led bailout of Mexico we — as well as a number of other sensible economists — warned that policy makers had erred in coming to the rescue and that it was bound to lead to a far greater problem in years to come. Unfortunately, it did. And once again, on renewed fears of spreading risks and bank failures, the IMF, on behalf of its developed countries' members, has stepped into the breach and organized, or at least attempted to organize, a new rescue operation.

The world has lost another opportunity to instill much-needed discipline to its banking community. If the bailout effort does not prosper, it is because it became too big to handle, not because the authorities did not try. Even then, the lesson will be that the authorities will try their best to save a bank from its own mistakes.

The above comments are not new to our readers, who have known our views in these matters for quite some time. We have thought it worthwhile to repeat them in that they provide a useful frame of reference to our next discussion, the possible consequences of these policy errors and some investment implications.

### Contagion?

The Asian problem, as we have noted, is not a plague that spreads and from which we could protect ourselves. It is the collapse of uneconomic financial structures merrily funded by reckless bankers and investors, who have now decided that they want out. These same bankers and investors engaged in similar reckless activities in Europe and particularly in North America.

Heretofore, strong economic growth has covered up the mistakes of lenders and investors. This blissful state is now about to change. Squeezed by falling output prices and rising input prices, mostly wages, US profit margins will shrink as surely as night follows day. The widening trade deficit will put further pressure on domestic production. Layoffs will reverse the fall in unemployment, which in turn will cause consumer credit to fall. Stock prices will fall, exacerbating the impact on weak consumer balance sheets. The stage will have been set for a bout of debt deflation.

This time around, monetary policy may not be as effective as it was in the past, given the consumer's already-high level of debt and the tremendous losses that the banking system will have taken on outstanding consumer credit. Fiscal policy, now moving in the direction of restraint and having achieved, after many years, a budget surplus, will be slow to reverse course. Barring a stroke of luck, the credit excesses of the past decade almost guarantee a North American recession of above average length and depth.

Debt deflation is the cure, not the disease. North America suffers from the same disease as Asia, namely excessive debt. To characterize the spreading crisis as a contagion is not only incorrect but misleading, because it deflects attention from

those responsible for the problem.

### IMF: Bankers' tool?

Earlier on, we made the case that the Asian rescue operation spearheaded by the IMF and the US Treasury was, from a welfare maximizing point of view, an incorrect response. Reckless lenders and investors must bear the consequences of their action. Otherwise a moral hazard problem is created, with nefarious future consequences.

We now are willing to advance the notion that even from a short-term point of view, IMF intervention is not justified. In the first place, it is far from clear that the well-capitalized North American and European banks, fat from seven prosperous years, would not be able to absorb loan losses to Asian borrowers. Compare, as an example, the amount owed to US banks by South Korea as reported by the BIS at \$10.3 billion and the combined market capitalization of *just* Citicorp, Chase, and J.P. Morgan at \$114 billion. Even if the amounts owed are understated because they take into account only loans booked out of the US, the need to invoke systemic risk as a reason to launch a rescue operation needs to be carefully documented.

In sum, loans to the Asian borrowers are well spread out and not all the borrowers are insolvent. Having learned a great deal from their Latin American and real estate experience of the '80s, banks have become experts in loan restructuring and workouts, almost guaranteeing that losses will never become total writeoffs.

Secondly, it is patently unfair. Short of sufficient cash, the IMF has asked private lenders, the world's largest banks, to roll over their short-term debt and, eventually, convert it to longer-term debt. In effect, the IMF has thrown Korea to the lions. For this “privilege,” the South Korean government, that is the South Korean taxpayers, are being asked to guarantee private company losses in exchange for loan rollovers. Lenders will not only not lose money from making bad loans, but will also earn new fees in connection with the rollover or conversion of short-term debt to longer-term obligations, receive higher interest payments as rates are reset upwards in line with prevailing spreads, and obtain the full faith and credit of the government. They make out like bandits. Can anything be more absurd?

Finally, an argument can be made that the bailout has worsened the foreign exchange crisis. A case-by-case resolution of the private debts, via restructuring, partial forgiveness, exchange for equity, or actual bankruptcy would have reduced significantly dollar buying pressure, because the size of the debt and the interest payments would have been reduced and its maturity stretched out over many years, not days and weeks.

Freezing the size of the debt at its present, artificial level implies a greater-than-necessary pressure on the foreign exchange market and a much lower equilibrium level for the won than warranted, as forex traders consider the size of the foreign debt in relation to exports and GDP. The unnecessary collapse of the won caused the unnecessary failure of hundreds if not thousands of enterprises.

One would hope that for fairness' sake alone, the South Korean government rejects the bankers' proposal to grant blanket guarantees to private banks and corporations and socialize the losses of the private sector. Could one be justified in concluding that the IMF works for the banks?

# Russia's rickety ruble

by Steve H. Hanke

The dramatic events in Asia have generated a torrent of commentary about exchange rates. Alas, most of that commentary has been either half-baked or flat-out wrong. Therefore, before we comment on Russia's rickety ruble, we are obliged to present some principles of exchange-rate regimes, principles required for sound analysis.

There are three types of exchange-rate regimes: floating, fixed, and pegged rates. Each type has different characteristics and generates different results. Although floating and fixed rates appear to be dissimilar, they are members of the same family. Both are free-market mechanisms for international payments.

With a floating rate, such as New Zealand's, a monetary authority sets a monetary policy, but has no exchange-rate policy — the exchange rate is on autopilot. In consequence, the monetary base is determined domestically by a monetary authority. However, with a fixed rate, such as Argentina's or Hong Kong's, a monetary authority sets the exchange rate, but has no monetary policy — monetary policy is on autopilot. In other words, when a country's official net foreign reserves increase, its monetary base increases and vice versa.

With both of these free-market exchange rate mechanisms, there cannot be conflicts between exchange-rate and monetary policies, and balance-of-payment crises cannot rear their ugly heads. Indeed, under floating and fixed-rate regimes, market forces act automatically to rebalance financial flows and avert balance-of-payments crises.

While both floating and fixed-rate regimes are equally desirable in principle, it must be stressed that floating rates, unlike fixed rates, do not perform well in developing countries, because these countries usually have weak monetary authorities and histories of monetary instability.

For a recent dramatic example, we have to look no further than Indonesia. It floated the rupiah on July 18, 1997. Unfortunately, but not surprisingly, the rupiah has not floated on a sea of tranquility. Indeed, the rupiah has fluctuated wildly and has lost 75% of its value against the greenback. In consequence, chaos has broken out, with people hoarding toilet paper, rice, and cooking oil.

Fixed and pegged rates appear to be the same. However, they are fundamentally different. Pegged rates are not free-market mechanisms for international payments. Pegged rates, such as Russia's and those that were employed throughout most of Asia before the recent currency crisis, require a monetary authority to manage both the exchange rate and monetary policy. With a pegged rate, the monetary base contains both domestic and foreign components. Unlike floating and fixed rates, pegged rates invariably result in conflicts between exchange rate and monetary policies.

For example, when capital inflows become "excessive" under a pegged system, a monetary authority often attempts to sterilize the ensuing increase in the foreign component of the monetary base by reducing the domestic component of the monetary base. And when outflows become "excessive," an authority attempts to offset the decrease in the foreign component of the base with an increase in the domestic component of the monetary base.

Balance-of-payments crises erupt as a monetary authority begins to offset more and more of the reduction in the foreign component of the monetary base with domestically created base money. When this occurs, it's only a matter of time before currency speculators spot the contra-indications between exchange rate and monetary policies and force a devaluation. This is what happened in Mexico in 1994. It is also exactly what happened last summer in Thailand and in other Asian countries with pegged exchange rates.

\* \* \* \* \*

This leads to the \$64,000 question: What will be the next pegged exchange-rate system to blow up, creating economic chaos? Russia's pegged system is a prime candidate. Indeed, it is vulnerable, particularly in the current hostile financial international environment in which the repricing of risk is proceeding with a vengeance.

Since July 1993, the ruble has been operating within a crawling peg system, with the nominal value of the ruble slowly depreciating in an orderly manner against the greenback (see Chart 6). On Nov. 10, 1997, the Russian central bank set the central parity at 6,200 rubles/US\$ and widened the fluctuation band to +/-15%. Incidentally, on Jan. 1, 1998, the ruble was redenominated, so that the new central parity is now 6.2 rubles/US\$.

Until October of last year, short-term interest rates, calculated on an annualized basis, for ruble-denominated debt had been rather stable at about 20%. But, with the troubles in Asia, the repricing of risk in emerging markets, and capital flight from Russia, the GKO (Treasury bill) rates have shot up to over 30% (see Chart 7). Incidentally, this nominal rate translates into about a 20% real rate. Although the ruble's peg has been maintained with these punishingly high interest rates, the central bank's total reserves declined from \$23.1 billion at the beginning of the fourth quarter of 1997 to \$19.3 billion at the end of the quarter. Given that \$4.5 billion of these reserves are held in gold that is encumbered as collateral, the net foreign exchange reserves declined to \$14.8 billion from \$18.6 billion in the fourth quarter, a whopping 20.4%.

As the troubles in Asia continue to wreak havoc on the international markets, Russia's vulnerability will become clear

for all to see, and the rickety ruble will come under great pressure. Either the GKO rates will have to go to the moon to defend the ruble or Russia will have to abandon its pegged exchange rate.

To appreciate this conclusion, we must look at Russia's balance of payments. The baseline projections for the summary balance of payments figures and central bank foreign reserves are shown in Chart 8. This baseline was constructed in December 1997 and is based on the assumption that the international environment would settle down and not deteriorate further. Events since December 1997 have shown that our long-held views about the potential for a massive deterioration in the international financial environment have been correct. We anticipate more trouble. In consequence, we have modified the baseline projections for Russia. Our alternate scenario includes realistic assumptions about how the deteriorating international environment will affect Russia's balance of payments and foreign reserves.

Our alternative scenario shows just how vulnerable Russia

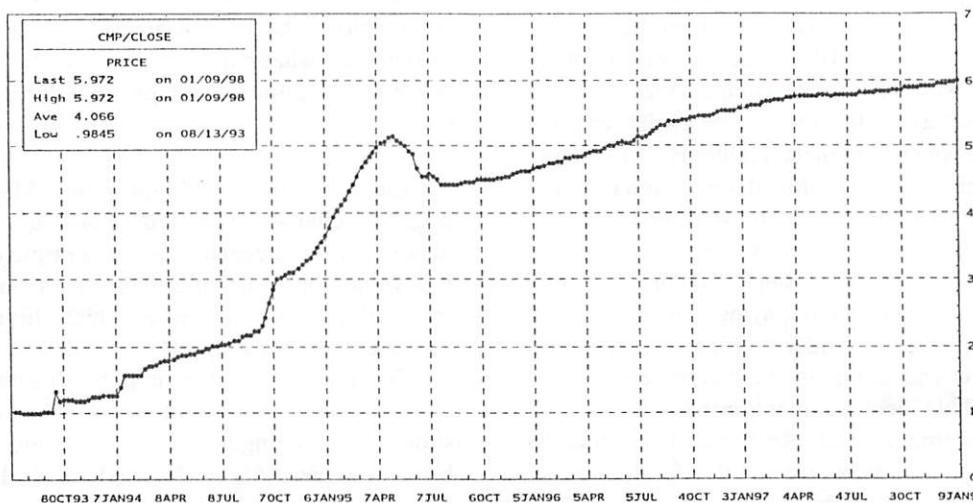
is. Indeed, by mid-year, if not before, Russia's foreign reserves will reach alarmingly low levels.

To avoid this disaster, Russia would have to implement dramatic fiscal and microeconomic structural reforms to restore investor confidence. Such dramatic moves by the Russians are not likely. In consequence, Russian short-term rates will move higher. Eventually the pain imposed will be too great for even the Russians to bear, and the ruble's pegged exchange-rate system will blow up, and the rickety ruble will be devalued.

In addition to the troubles this will generate in a country as unstable as Russia, a ruble devaluation will send shock waves into Central and Eastern Europe. And, yes, it will also motivate more repricing of emerging market risk and a further deterioration of the international financial environment.

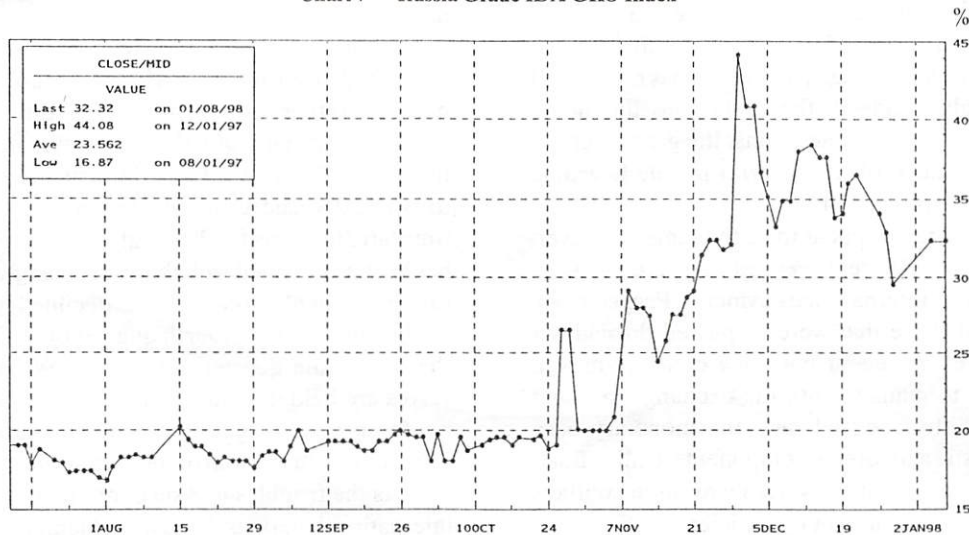
*Steve H. Hanke is Professor of Applied Economics at Johns Hopkins University, a regular columnist at Forbes magazine, and Chairman of Friedberg Mercantile Group, Inc. in New York.*

Chart 6 – Russian Ruble - Spot



Bloomberg

Chart 7 – Russia Grade IDX GKO Index



Bloomberg

Chart 8  
Russia's Balance of Payments Scenarios\*

	Baseline			Alternate Scenario	
	Q <sub>4</sub> 97	Q <sub>1</sub> 98	Q <sub>2</sub> 98	Q <sub>1</sub> 98	Q <sub>2</sub> 98
Current Account	0.2	0.5	-0.7	-0.5	-1.7
Capital Flows	-4.0	-0.2	-0.2	-9.2	-1.2
Overall Balance (Current Acct. + Capital Flows)	-3.8	0.3	-0.9	-9.7	-2.9
Foreign Reserves (end of Q) (Foreign Exchange + Gold)	19.3	19.6	18.7	9.6	6.7
Foreign Reserves (end of Q) (Foreign Exchange Only)	14.8	15.1	14.2	5.1	2.2

\*All figures are in billions of U.S. dollars

Notes:

1. Baseline source: CS First Boston
2. Assumptions for Alternative Scenario vs. Baseline:
  - The remaining non-resident holders of Treasury Bills (GKO) liquidate \$4 billion in both Q<sub>1</sub> 1998 and in Q<sub>2</sub> 1998 and repatriate the proceeds.
  - Capital flight and non-payments by buyers of Russian exports increase by \$5 billion in Q<sub>1</sub> 1998.
  - Disbursements by the IMF, WB, EBRD increase by \$2 billion in Q<sub>2</sub> 1998.
  - Syndicated finance from foreign banks increase by \$1 billion in Q<sub>2</sub> 1998.
  - Due to the negative terms of trade shock from lower energy and metals prices the current account deteriorates by \$1 billion in both Q<sub>1</sub> 1998 and in Q<sub>2</sub> 1998.

**STOCK MARKET**

**The beginning of the end**

There is now little doubt in our minds that the peak reached on August 7 will stand as the all-time high of the most spectacular bull market in history. It has taken a little bit over five months for the selling forces to overcome the slowly waning band of diehard bulls. Mutual fund inflows confirm the slow motion yielding action of the forces of good to the forces of evil: Investors bought a net US\$18.06 billion in stock funds in November, a tad less than the US\$18.5 billion in September. Significantly, for the 11 months, investors moved US\$213 billion into equity portfolios versus US\$210 billion a year earlier, despite the fact that the market on average is approximately 30% higher than last year. As well, more and more corporate takeovers are being effected via stock swaps rather than hard cash, another sign that these rarefied levels are no longer attracting enough buying enthusiasm.

Subsurface technical analysis confirms a steady weakening. Our own trend analysis of the 30 components of the Dow Jones Industrial Average reveals a glaring divergence with the performance of the Dow Jones Industrial Average around early December (see Charts 1A and 1B). Clearly, the index is weaker than meets the eye.

The market's inability to take strength from the daily new lows in bond yields speaks volumes about its most immediate concerns: the impact of rising wage costs and falling prices on corporate profits.

If our scenario as outlined above pans out, stock prices should fall anywhere between 40% and 70% from these levels.

**STRATEGY:** Remain short.

Chart 1A

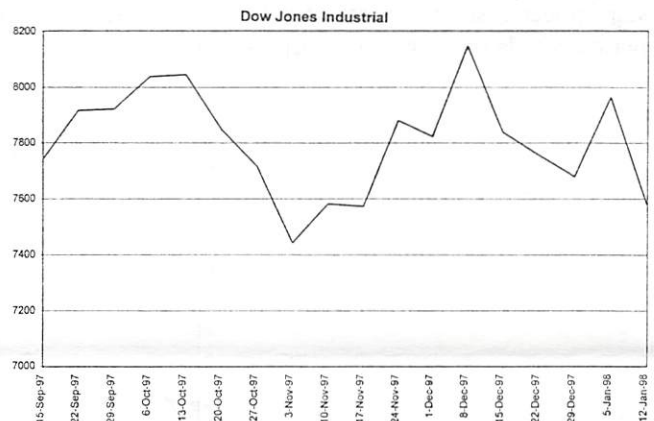
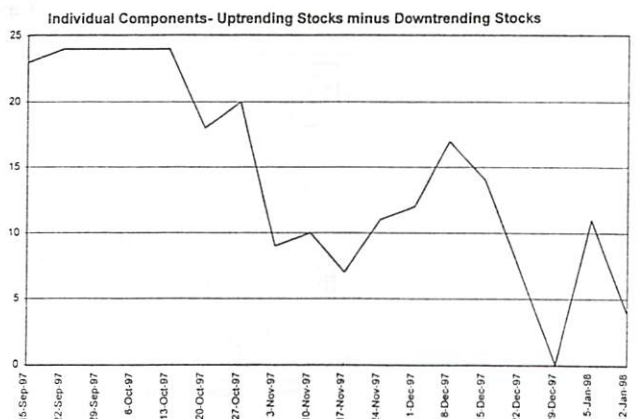


Chart 1B



# Playing deflation

Debt deflations (see "1998: Annus mirabilis" on Page 1) are no fun — unless of course you are long Treasuries.

We do want to make a distinction between our camp, the camp of the debt deflationists, and the camp of the price deflationists. With M2 running at the top of the Federal Open Market Committee's objective set at 1% to 5% and M3 running well above the 2% to 6% objective, and with M2 velocity finally becoming more predictable (see Chart 2), there is a real danger that accelerating inflation rather than outright deflation will rear its ugly head.

Debt deflation is generally a painful process, accompanied by mounting business failures and personal bankruptcies and is typically characterized as a recession. It need not be accompanied by falling prices. In this type of environment, credit spreads tend to widen and long-term interest rates are as likely to fall as to rise.

Price deflations, on the other hand, common in the Gold Standard era of the 19th century, can be relatively peaceful affairs, very often accompanied by good economic growth. For example from 1879 to 1897, prices fell at the rate of over 1% a year, while the aggregate net national product in constant prices rose at the rate of 3.7% per year. During this period, yields on high-grade corporate bonds fell to 3.66%

from 5.22%. Industrial bond yields, too, fell to 5.12% from 6.68%. There is little indication that credit spreads widened, if at all.

The view that we may be entering a period of price inflation is gaining ascendancy, particularly after comments made by Fed Chairman Alan Greenspan and Laurence Meyer, one of the most hawkish of Fed Governors. Such a view translates into falling long-term yields. So far so good. Where we part company is in the choice of instruments and on the holding period. We choose Treasuries over junk bonds, emerging market debt, corporate bonds, and of course common stocks, all of which will be deeply affected by widening credit spreads (see our November 1997 issue: "The re-pricing of risk..."). Our holding period will necessarily be shorter; we are certainly not prepared to buy 30-year securities and lock them up.

A reversal of the US dollar uptrend and the onset of a US recession may be our earliest indicators that the era of falling yields has come to an end.

**STRATEGY:** Remain long March '97 T-bonds, raising stops to 120.16, close only. Cash accounts would do well to maximize duration by buying Treasury strips.

Chart 2

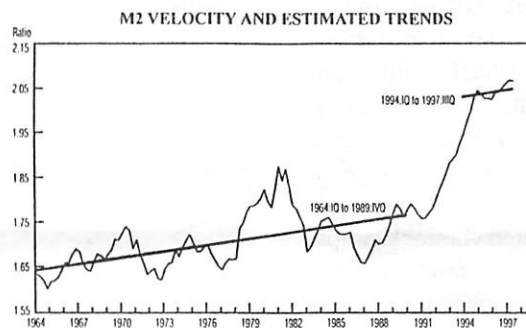
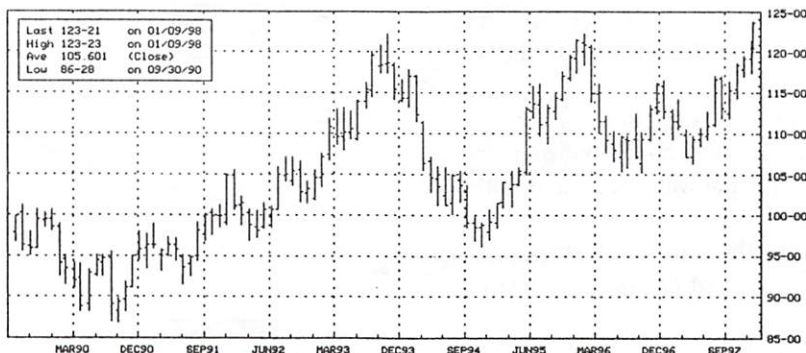


Chart 3 — T-bonds



**JAPANESE YEN**

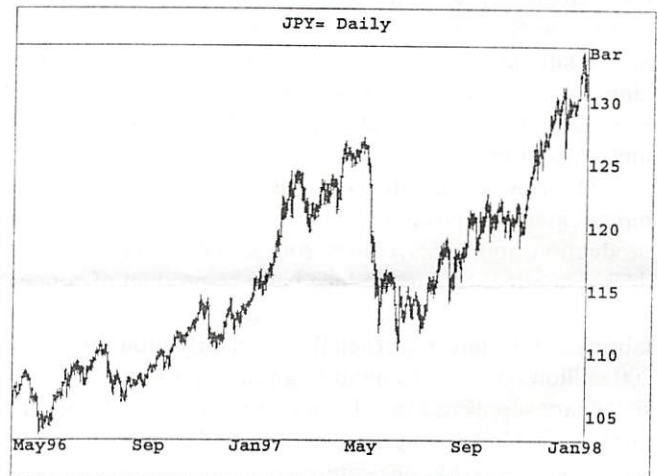
## On the brink of collapse

Once again, the Japanese government has backtracked from putting into motion an effective and realistic solution to its banking crisis. Having proposed contributing the not inconsiderable sum of ¥30 trillion of public monies to the Deposit Insurance Corporation, it now appears to want to redirect two thirds of these monies to the purchase of preferred shares in banks acquiring failing institutions. This practice is certain to spread the rot infesting the financial system to the healthier banks. Only one third of the funds will go to recompensing depositors in failed institutions.

Japan is now in a full blown recession, with a banking system on the brink of collapse and a government unwilling to put into place a sensible and transparent lifeboat. Here, too, events are about to overtake men.

**STRATEGY:** *Remain short yen and banking shares.*

Chart 4

**GOLD**

## The trend is your friend

While there is a great deal of information in the newly released Gold Fields Mineral Services Limited *Gold 1997* report, there is little that convinces us that demonetization is not the single most important, and perhaps the only important, price-making factor. At 393 tonnes, official sector disposals were more than double the average recorded over the preceding 10 years of 213 tonnes, although it was exceeded both in 1992 and 1993 when net sales amounted to 622 and 484 tonnes respectively. Fourteen countries reduced their gold holdings last year by some 825 tonnes. Gold Fields points out that on the purchase side, it appeared that some 19 countries absorbed

around 432 tonnes last year and that a substantial part of this gold consisted of locally-acquired mine production.

Regardless of the near-term changes in fabrication demand (strong of late) and mine production (still rising but due to fall next year), "the market remains obsessed with the presumed 'overhang' of 35,000 tonnes of official sector gold holdings."

As the saying goes, the trend is your friend.

**STRATEGY:** *Remain short, lowering stops to \$300/oz., basis February 1997, close only.*

**SILVER**

## Conspiracy theories

The silver market has broken from the pack. Not only has it defied the trend of sliding prices in commodities as a whole, it has torn itself from family. For most of this decade, the relationship between gold and silver fluctuated at a ratio of between 70-to-1 and 90-to-1. We would refer to the two markets as "the precious metals." Significant moves in prices of either would bring the other along, eventually.

That, however, was a different era. Today, they may or may not be precious, you can decide, but each moves on its own merits. Central banks around the globe are in the process of demonetizing gold, which has set it on its own downward spiral. This selling power has allowed gold to push

below 1985 lows and have a life of its own. The silver market has not sat idly by, watching from the sidelines. A stunning rally from last summer's low of \$4.20 an ounce propelled silver as high as \$6.40 an ounce, a rise of 50%, top to bottom. The market has backed off the highs to close out this past week at just above \$5.60 an ounce, but still at lofty levels and representing a ratio to gold of 49-to-1. Are the supply/demand fundamentals in silver so bullish as to warrant this?

Ever since the "Hunt Brothers' bubble" burst back in 1980, silver prices have been in decline. The lure of a market that had increased tenfold in a period of two years caused a series of dramatic rallies over the years. However, in classic

bear market fashion, the market ultimately took out the lows that were in place before the Hunt Brothers' spike. The market has spent the 1990s trading between \$4.00 and \$5.50 an ounce. What makes this rally interesting technically is that it has met price levels not seen since 1989.

Another departure from tradition that gives the rally some credibility is that the "precious metals" were once seen as a hedge against inflation. In an environment where fears are deflationary rather than inflationary and the other precious metal is making almost daily new lows, we can feel confident that the market has moved on factors that are unique to silver.

The 18-year slide in prices has ensured that pure silver mines cannot be profitable. Only a small amount of annual production, about 15%, comes from actual silver mines these days. The other 85% is produced as a by-product of copper, lead, zinc, and gold mining. Looking at production against fabrication demand superficially will clearly show deficits of 200 million ounces-plus mounting year after year. However, secondary supply of some 150 million ounces is fed into the market, making the deficits much smaller. And we must remember that unlike agricultural commodities, all the silver that has ever been mined is still around and comes out of the closet when the price is right.

For the moment, silver has been disappearing. Comex warehouse stocks have dropped dramatically. Since they peaked last summer at over 200 million ounces, the stocks have been vanishing systematically; there are only 110 million ounces remaining, a slash of almost 50%. As well, there have been large shipments out of warehouses in London, but figures are not reported, making it impossible to know the amount.

India's imports are growing year by year. It imported 100 million ounces in the first 8 months of 1997, a jump of 50% from the same period in 1996. There has been solid demand from the electronics and photographic industries. Fear of digital imaging destroying the conventional film market are unfounded, as the quality gap is still enormous. While these demand-side factors are significant, they are likely not enough to have allowed silver prices to depart from both related and unrelated commodities in such a dramatic fashion.

With the demand for virtually every single industrial commodity sinking, as seen in collapsing prices of base met-

als, petroleum, fibre etc., it is hard to make the argument that the shrinking stockpiles have gone to meet bona-fide demand, that is, industrial usage. Rather, the most likely scenario is an attempt by some parties to produce a sequel to the Hunt Brothers' market.

This is hardly the stuff of conspiracy theory or something we cooked up. As far back as October 20 when silver was still hovering at \$5.00 an ounce, Merrill Lynch's respected Metal Analyst, Ted Arnold, indicated that there is a group of hedge funds and traders that is attempting to corner the silver market: "The syndicate takes the view that he who controls the stocks is the master of the market..." Gold Fields Mineral Services Ltd., which produces the most widely followed set of statistics on the silver market stated at about the same time: "There have been examples in the past of manipulation, and you can't rule out the possibility it could happen again..."

In the all-important arena of sentiment indicators, we find two conflicting readings. The open interest has been relatively tame. At 95,000 contracts, it is not low — but not as high as silver open interest can get. In early 1995 the open interest got to as high as 140,000 contracts. On the other hand implied volatility, a measure of option-writer complacency, shows that the pros are not taking any chances and are making buyers pay up. The "vol" is running at 38%. Until early November it was averaging 20% to 25%. Folklore holds that the move is on its last legs when such a formation is evident.

Rather than viewing the "syndicate" in a judgmental fashion and referring to them as "manipulators," we take the view that their purchases do represent bona fide demand — but that it is investment demand and not industrial. In a world of collapsing equity markets and vulnerable high-flying ones, they seek to preserve their capital by purchasing assets that have longevity. They are merely betting on the price, as do we all when we speculate. How strong is their nerve and how deep are their pockets? We watch the market for answers to these questions. If it seems that the answers are strong and deep, we will ride along.

**STRATEGY:** *Wait.*

— **Sholom Sanik**

## **COPPER**

# The perfect bear

Copper prices have declined almost 40% since this past summer. All aspects of this market have joined forces to create the perfect bear market, as if a script had been written and followed to a tee.

Production has not let up. According to the International Copper Study Group, total world refined production rose by 7.5% in the first nine months of 1997 to 10.079 million

tonnes. While consumption grew, it did so at a rate of only 4.8% for the same period. Chile, after producing 3.43 million tonnes in a blockbuster 1997, is expected to produce 3.8 million tonnes this year, an increase of 10%.

Looking to the consumption side further dims any hope of a recovery in prices. The Chinese were always looked upon as the buyer of last resort, because they must feed their

own smelter industry. In reality the Chinese were handing out a subsidy to their domestic industry. We now read that they are no longer willing to engage in this subsidy program. Third-quarter imports were 212,000 tonnes, which was down 17% from the third quarter of 1996, and 18.5% from the previous quarter. With 200,000 tonnes, give or take, in their strategic reserve stockpile, we must count them out as buyers, for now.

Then we begin to see the first serious impact on copper consumption from the Asian crisis. Over the weekend, the Indonesian government announced that it is reconsidering or delaying 15 infrastructure projects. Just to illustrate the scope of these measures and their direct hit on copper usage, consider the cancellation of the building of an airport and several power plants. These 15 projects were the balance of a planned 150 projects that were already shelved a couple of months ago. Traders say that Indonesian imports could fall to as low as 50,000 tonnes in 1998 from as much as 250,000 tonnes in 1997, while total South Korean demand could fall by as much as 45%.

After shedding about 15,000 tonnes from the highs, warehouse stocks seemed for a moment to be giving some way, indicating that prices had sunk far enough and buyers were emerging. It was not to be, however, as the stocks have come back in and are just below the highs at 341,000 tonnes.

The debate with regard to whether this market is in surplus is clearly over. The market will fluctuate, but it is clear that this market will be quoted in cents per pound for some time to come. The market will stabilize at some point, but there is precious little bullish to say about the balance between supply and demand. Merrill Lynch predicts that high-cost mines will be forced to close, but not until the end of 1998.

The market continues to be stingy with its rallies. On the rare occasions that the market opens a cent or so higher, the gains vanish by mid-day. We keep our eyes open for opportunities to sell this market.

**STRATEGY:** *Stand aside for now.*

— Sholom Sanik

## SOFT COMMODITIES

### Cocoa

Cocoa prices have tried to break through the \$1,700-a-tonne barrier three times since this past summer without much success. Fears that El Niño would wreak havoc with weather patterns in the two main growing areas, West Africa and Southeast Asia, were responsible for much of the buying power. As arrivals are beginning to match those of last year's record crop in the Ivory Coast, these fears are abating, and it is reflected in the price. March cocoa finished the week at \$1,564, which rests exactly at a weekly uptrend-line that dates back to February of last year.

While it is true that we are likely facing yet another year of a production/consumption deficit, this statistic does not seem to be scaring too many people. The numbers published by the popular analysts seem to indicate that hardly a dent has been made in the burdensome carryover stocks. For a while, the threat of the ICCO orchestrating a cartel of sorts kept some life in prices, but the recent ICCO conference ended with no such agreement.

The negative bias could be easily seen this past week as two of the four countries that publish grinding statistics reported fourth-quarter results. Dutch fourth-quarter grindings came in above the high end of expectations with an increase of 5.94% over the fourth quarter of 1996. The UK, which was expected to be unchanged to lower, because of the shifting of grindings to both origin countries and the Dutch, had a modestly friendly increase of 1%. Yet, the market closed out the week at a six-week low.

German cocoa traders Albrecht and Dill confirmed in a report this week what we've pointed to several times in the

past. The grinding statistics released by the Dutch, Germans, the UK, and the US are no longer a reliable means by which to judge consumption. Much grinding has shifted to origin countries. It will take time for a proper Western-style reporting system to be developed in the origin countries.

Without exception, the producers are Third-World countries and cannot be relied upon to produce accurate statistics. One needn't go much further than the Ivory Coast itself. The government's official estimate of production is always miraculously 150,000 tonnes less than just about every other analyst. Rather, Albrecht and Dill suggest, the market must concoct a new system that will include Western grindings, estimates of origin grindings, and import data.

All this does not go a long way to telling us which direction consumption is heading. It tells us only that we must follow the market carefully by watching the activity of commercials who are probably in the best possible position to know what the confused state of reporting is hiding. According to Steve Briese of *Bullish Review* (January 1) whose business it is to know these things, the commercials' portion of the open interest indicates a neutral stance.

The contango makes it clear that there is no tightness in this market and adds a measure of comfort to being short. Chocolate consumption can be viewed as a luxury, and while we find ourselves in the midst of the ripple effect of the Asian crisis, it is difficult to see demand growing much in the near term.

**STRATEGY:** *Remain short; lower stops to 1625, basis March 1998, close only.*

## Soy complex

The single most prominent factor that is setting the tone for movements in the prices in the soy complex is the Asian crisis. Declining economic activity is expected to put the brakes on booming demand. Fear that the record crop harvested by US farmers and the coming record Brazilian crop will overwhelm price levels that have factored in a continuous flow of Asian demand.

Soybean prices have been declining since the "Asian Crisis" became a media event back in the fall. They now sit midway between the summer bottom at \$6.00 per bushel and the early November peak of \$7.50 per bushel. Part of the decline was certainly attributable to harvest selling pressure. Nonetheless, the issue will remain whether the torrid pace of exports can last in an environment where the buyers are facing austerity programs and dwindling purchasing power because of vanishing currency values.

Export commitments this past week have shown a bit of weakness, but still indicate a steady flow of business. When taken in the perspective of an average of the last five periods since our last letter, we are still running well out in front of the USDA estimates for the season. Both soybean and meal commitments already total 70% of the USDA projection. The market will watch these statistics with great interest in the coming weeks.

Amongst edible oils, soybean oil has a 29% share of the world market. Palm oil is second at 23%. Both are then quite important to supply, and with palm oil supply possibly in trouble, importers around the globe will come knocking for American beanoil. Until recently, a vast majority of beanoil produced in the US was consumed at home, but as we will illustrate, this is changing. In the 1995-96 season, soybean oil exports accounted for a mere 7% of total supply in the US. In 1996-97 exports of oil grew to 11% of supply. This season, based on the USDA estimate, exports of oil will account for 13%. This reflects the growing demand for edible oils globally, as palm oil exports have grown as well.

Palm oil production was cited as one of the most vulnerable to the much-blamed El Niño weather pattern. The jury is

still out on the effect it had on production in the two key producers of palm oil, Malaysia and Indonesia. Some statistics have emerged, however, that reinforce the notion that US beanoil will be much sought after. Probably the most important occurrence was the banning of palm oil exports for the first quarter of 1998 by the Indonesian government late in December, to ensure that its domestic market will have adequate supplies. Initially, the business will shift to Malaysia. The market in Malaysia is already under pressure, though, as exports for the month of December were up sharply over November. This coming even before the Indonesian ban on exports takes effect. Then came word that Malaysian palm oil production for December was down 20% over November. In fact, a private forecaster has confirmed that this was a result of yields that were lower for this time of year than in recent years. Perhaps this is the first shade of El Niño damage to the oilseed market.

Bill Gary, author of the well-regarded agricultural newsletter *Price Perceptions*, has been the staunchest of bulls in the soy complex. He has recently turned negative. In the January 10 issue, he focuses on the fallout of Asian crisis and can definitely be considered bearish. He does, however, say that collapsing crush margins have made products cheaper than beans and will probably keep exports of products strong. Despite his bearishness, tucked neatly into the end of his piece on the soy complex, he recommends selling the spread in both beans and oil, expecting tightness to emerge that would close the spread in each. Specifically, with respect to the point we are driving at, he predicts, "We expect March soybean oil to eventually trade equal, or at a premium to, July oil."

Keeping in mind that US exports of soybean oil had been growing long before anyone but the most hawkish and pessimistic economists even dreamed of an Asian crisis, we are still watching this market.

**STRATEGY:** *Stand aside.*

— Sholom Sanik

**Chart 10 — Friedberg Capital Markets  
Recommended current portfolio allocations**

1. US Treasury Strips 0% '25 (US\$)	40%	4. US Treasury 6.25% '02 (US\$)	7.5%
2. KIPT 9% cv (NZ\$)	15%	5. Trans Tasman 9% '99 (NZ\$)	5%
3. US Treasury 6.375% '27 (US\$)	20%	6. 10-year BUNDS, hedged (US\$)	12.5%

Chart 9 – FOREIGN CURRENCY BONDS

DATE: January 9, 1998

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
<b>DEUTSCHE MARK DENOMINATED BONDS</b>					
World Bank 7 1/4% 13/10/99 RRSP eligible	104.65	105.50	3.92		Oct-13
World Bank 9% 13/11/00 RRSP eligible	111.45	-	-		Nov-13
Kingdom of Denmark 6 1/8% 15/04/98	100.00	100.85	2.62		Apr-15
Argentina 8% 5/10/98	100.85	-	-		Oct-05
Kgdm. of Spain (6 Mo. LIBOR-1/16) 29/6/02 (semi)	99.80	100.10	-	3.75	Jun-29
<b>CZECH REPUBLIC KORUNA BONDS</b>					
General Electric Cap. Corp. 10.5% 23/10/98	94.50	-	-		Oct-23
Nordic Inves. Bk 10.625% 10/11/00	89.10	-	-		Nov-10
Intl. Fin. Corp 10% 30/4/98	97.00	-	-		Apr-30
<b>SWISS FRANC DENOMINATED BONDS</b>					
General Electric Cap. Corp. 4 3/4% 2/7/98	100.75	-	-		Jul-02
General Electric Cap. Corp. 4 1/2% 17/12/99	103.90	-	-		Dec-17
<b>DANISH KRONE DENOMINATED BONDS</b>					
Kgdm. of Denmark 9% 15/11/98	103.30	104.15	3.83		Nov-15
<b>ECU DENOMINATED BONDS</b>					
United Kingdom 9 1/8% 21/02/01	112.30	113.15	4.48		Feb-21
<b>BRITISH POUND DENOMINATED BONDS</b>					
European Inv. Bk. 7% 22/12/98	99.00	99.85	7.14		Dec-22
Kgdm. of Denmark FRN 28/8/98 3mo LIBOR-12.5b.p.(qtlly)	99.70	-	-	7.625	Feb-27
<b>CANADIAN DOLLAR DENOMINATED BONDS</b>					
Ontario Province 10 5/8% 15/7/98 RRSP eligible	102.05	103.30	3.74		Jul-15
Petromet Resources 6.5% 31/3/04 (semi) CV @ \$9.50 p/sh	89.25	-	-		Mar-31
<b>SOUTH AFRICAN RAND DENOMINATED BONDS</b>					
ESCOM 11% 1/6/08 (semi)	84.35	85.85	13.58		Jun-01
<b>AUSTRALIAN DOLLAR DENOMINATED BONDS</b>					
Toronto Dominion Bk. Aust. 7.25% 26/2/99 RRSP eligible	102.50	103.35	4.11		Feb-26
<b>NEW ZEALAND DOLLAR DENOMINATED BONDS</b>					
World Bank 8.25% 30/4/99 RRSP eligible	100.15	101.00	7.36		Apr-30
New Zealand Gov't 8% 15/7/98 (semi)	99.10	99.95	8.17		Jan-15
Ontario Province 7.15% 24/11/98 (semi)	97.75	-	-		May-24
Fletcher Challenge 10.15% 30/11/98 CV (semi)	99.30	100.15	9.94		May-31
Tranz Rail Ltd. 10% 15/10/99 (semi)	100.00	100.85	9.44		Apr-15
Trans Tasman 9% 27/6/99 CV (semi)	91.95	92.80	14.67		Jun-26
St. Luke 8.7% 1/4/99 (semi) CV @ 1.00 p/sh	143.30	145.30	14.98		Apr-01
Kiwi Income Prop. Trust 9% 30/9/03 CV (semi)	111.20	113.20	10.39		Mar-31
<b>ARGENTINEAN PESO DENOMINATED BONDS</b>					
Bocon Pre 1: 1/4/2001	PAR VALUE 112.5682	98.25	100.00	IRR 12.10	Feb-01-98
<b>U.S. DOLLAR DENOMINATED FIXED CONV. BONDS</b>					
Coeur D'Alene 6% 10/6/02 CV@ 26.00 p/sh	69.00	70.50	15.75		Jun-10
JumboSports 4 1/4% (semi) 11/1/00 CV @ 25.5 p/sh	37.25	-	-		May-01
The Learning Co. 5 1/2% (semi) 11/1/00 CV @ \$53.00 p/sh	87.25	88.75	10.22		May-01
Novacare Inc. 5.5% (semi) 15/1/00 CV @ \$26.65 p/sh	93.75	95.25	8.12		Jan-15
<b>U.S. DOLLAR DENOMINATED FIXED RATE BONDS</b>					
U.S. Treasury 6.25% (semi) 28/2/02	102.95	103.25	5.36		Feb-28
U.S. Treasury 6.375% (semi) 15/8/27	108.30	108.90	5.75		Feb-15
U.S. Treasury Coupon Strips 0% 15/2/25	20.70	21.00	5.84		Feb-15-25
U.S. Treasury Principal Strips 0% 15/2/25	20.70	21.00	5.84		Feb-15-25
Queensland Tres. (Gold Bull) 2% 4/3/98	94.40	94.50	5.66		Mar-04
World Bank 7 1/8% 27/9/99 (semi) RRSP eligible	102.40	103.25	5.10		Mar-27
Mobile Telecomm 13.5% (semi) 15/12/02	116.25	117.10	9.11		Dec-15
<b>U.S. DOLLAR DENOMINATED FLOATING RATE NOTES</b>					
Canada Gov't 10/2/99 3 mo. LIBOR - 1/4 (qtlly), callable @ 100 RRSP eligible	99.77	100.07	-	5.5625	Feb-13
Bocon 1/4/01 (30 day LIBOR) starts paying May 1, '97	PAR: 107.9555 101.00	-	-		Feb-01-98
Argentina: Series L:FRB 31/3/05, 6 mo. LIBOR+13/16 (semi)	PAR: 96 87.00	88.50	10.02	6.6875	Mar-31
Venezuela: DCB: 18/12/07, 6 mo. LIBOR+7/8 (semi)	PAR: 95.2381 86.50	87.35	10.35	6.8125	Jun-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, December 9, 1997:

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

### Friday, December 12, 1997:

Good afternoon for Friday, December 12. There are no changes or new recommendations.

### Flash Update: Wednesday, December 17, 1997:

Good afternoon for Wednesday, December 17, 5:00 pm. This is a flash update. Sell March cocoa at the market, placing stops at 17.67, good anytime.

### Flash Update: Thursday, December 18, 1997:

Good afternoon for Thursday, December 18, 5:00 pm. This is a flash update. Sell March Dow Jones at the market, placing stops at 8270, good anytime.

### Friday, December 19, 1997:

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

- On Wednesday, December 17, via flash update, we advised selling March cocoa at the market, placing stops at 1767, good anytime. On Thursday, March cocoa opened at 1692.
- On Thursday, December 19, via flash update, we advised selling March Dow Jones, at the market, placing stops at 8270, good anytime. On Friday, the March Dow Jones opened at 7884.

### Flash Update: Tuesday, December 23, 1997:

Good morning for Tuesday, December 23, 10:15 am. This is a flash update. Buy March silver at the market, presently trading at 609.00, placing stops at 550.00, close only.

### Friday, December 26, 1997:

Good afternoon for Friday, December 29. There are no changes or new recommendations. The following is a recap of this week's recommendations.

- On Tuesday, December 23, 10:15 am, via flash update, we advised buying March silver at the market, trading at 609.00, placing stops at 550.00, close only.

### Tuesday, December 30, 1997:

Good afternoon for Tuesday, December 30. There are no changes or new recommendations.

### Friday, January 2, 1998:

Good afternoon for Friday, January 2. There are no changes or new recommendations.

### Tuesday, January 5, 1998:

Good afternoon for Tuesday, January 5. There are no changes or new recommendations.

### Flash Update: Friday, January 9, 1998:

Good morning for Friday, January 9, 11:25 am. This is a flash update. Liquidate March silver at the market, presently trading at 570.00, cancelling the previous stop of 550.00, close only.

### Friday, January 9, 1998:

Good afternoon for Friday, January 9. This is a complete summary since our last market letter dated December 5, of all liquidations of open positions and new recommendations that remain outstanding.

- On Wednesday, December 17, via flash update, we advised selling March cocoa at the market, placing stops at 1767, good anytime. On Thursday, March cocoa opened at 1692.
- On Thursday, December 18, via flash update, we advised selling March Dow Jones at the market, placing stops at 8270, good anytime. March Dow Jones opened on Thursday, December 17 at 7884.
- On Tuesday, December 23, via flash update, we advised buying March silver at the market, then trading at 609.00, placing stops at 550.00, close only.
- This morning, via flash update, we advised liquidating March silver at the market, then trading at 570.00, cancelling the previous stop of 550.00, close only.

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. Contents copyright © 1998 by Friedberg Commodity Management Inc. All rights reserved. Reproduction in whole or in part without permission is prohibited. Brief extracts may be made with due acknowledgement.

**Subscription Enquiries for**  
Friedberg's Commodity & Currency Comments  
P.O. Box 866, Suite 250  
BCE Place, 181 Bay Street  
Toronto, Ontario, Canada  
M5J 2T3  
(416) 364-1171

**Trading and Managed Accounts**  
All enquiries concerning trading accounts should be directed to:  
**In Canada**  
Friedberg Mercantile Group  
P.O. Box 866, Suite 250,  
BCE Place, 181 Bay Street  
Toronto, Ontario M5J 2T3  
(416) 364-2700  
**In U.S.**  
Friedberg Mercantile Group Inc.  
67 Wall St., Suite 1901  
New York, N.Y. 10005  
(212) 943-5300

All statements made herein, while not guaranteed, are based on information considered reliable and are believed by us to be accurate. Futures and options trading is speculative and involves risk of loss. Past trading results are not indicative of future profits.

The U.S. broker-dealer, Friedberg Mercantile Group, Inc. NY, takes full responsibility for the contents of this market letter. U.S. residents wishing to effect any transactions in any security discussed in this report should contact Friedberg Mercantile Group, Inc. NY, toll-free at 1-800-474-2663.