

FRIEDBERG'S

COMMODITY & CURRENCY COMMENTS

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Money, money, money everywhere: Can inflation be far behind?

It may seem odd to bring up the threat of inflation just as the US Producer Price Index plunged 0.7% in January and was down 1.8% from a year earlier. And yet, monetary conditions in the US, UK, and even Japan are so loose that they are flashing red. As the deflationary "momentum" kicked off by the Asian collapse wears away, the pace of consumer prices in some of the major industrialized centers will reaccelerate. Needless to say, financial markets do not seem particularly well prepared for this eventuality.

First, a simple introduction. The crude quantity-theory of money, popularized by Irving Fisher (1911), held that money times its turnover rate (also called velocity) equaled nominal income (real income times inflation). As a result, a 10% increase in money would cause a 10% increase in income if, and only if, velocity did not change. (Naturally, a rise in velocity would amplify, and a fall would offset, some or all of the effect).

Despite the many challenges, the theory survived conceptually and served, for a few years, as the basis for central bank policy in, among other countries, the US, Canada, and Germany (where it is still operational). Where monetarism — as the central bank application of the quantity theory of money was called — ran into trouble was in the definition of money. Intuitively, the narrow definition of money (M1) — that is, currency and demand deposits — responded well to the definition of money sought — the most proximate means of payment in a modern economy (in the 19th century it would have been only currency).

Unfortunately, the steady and predictable rise in narrow money velocity of the '70s came to an abrupt end around 1980, throwing a monkey wrench into the monetarist equation. As velocity became an unknown, it was no longer worthwhile to target the growth of money supply. Monetarism in the US, Canada, and other countries was discarded in favor of much more eclectic and discretionary policies.

What caused narrow money supply velocity to reverse course and enter a long fall? Or, what is essentially the same, what caused people to hold *larger* amounts of means of payment in relation to their incomes? This was particularly difficult to answer in view of the technological strides that had been achieved (such as the increasing use of credit cards) that allowed households and businesses to *economize* on transaction balances. The obvious answer was confidence, confidence that inflation had been contained and that it would no longer erode the value of their non-interest bearing

means of payment (currency and checking account balances).

From 1979 to 1982 Paul Volcker, then governor of the Federal Reserve, earned this confidence via a massive tightening of monetary conditions that saw short-term interest rates soar to 21% and key commodity prices collapse by more than 50%. In the tug between technological factors pulling in the direction of reduced balances and disinflationary factors pulling in the direction of larger and more comfortable balances, the latter prevailed. From March 1982 to March 1994 (see Chart 1), velocity fell irregularly but persistently by a total of almost 20%, or approximately 1.5% per annum. As households and businesses "absorbed" some of the increases in narrow money by willingly holding on to larger balances, inflation was further restrained.

It now appears that this anomalous behavior — one that was so helpful to the monetary authorities even as it was almost unknown to them (one never hears or reads in the Fed deliberations and speeches about velocity, let alone narrow money velocity) — came to an end in early 1994 (see again Chart 1). The end of the downtrend in velocity was confirmed in early

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Contributions by Albert D. Friedberg and Sholom Sanik.

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

1997 when velocity "sped" through the previous 1990 "peak."

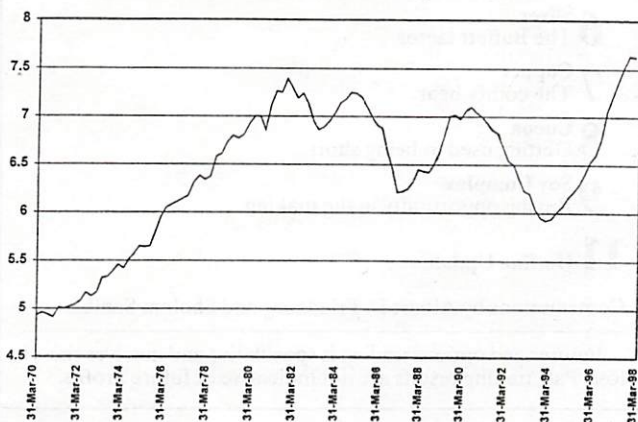
Short of a new deflationary shock, there is no longer any doubt that the downward pull in velocity caused by disinflation has ceased. The one-time adjustment (over a 12-year period) to disinflation has been accomplished: Households and businesses have adjusted their transaction balances to desired levels. Technological factors are set to regain the upper hand: Sweep accounts, credit cards, and money market accounts will continue to help economize transaction balances. Velocity will accelerate, complicating the future conduct of monetary policy. This complication is given by the postulates of the earlier equation: Rising velocity will amplify the effect on nominal income of any increases in money.

While narrow money was almost unchanged from a year ago, it has recently perked up, rising at an annual 4.5% over the past 3 months. Assume a trend annual increase in velocity of 3.5% (about half its recent pace), and a continuation of the most recent 4.5% growth in money, and one is left with a prospective growth in nominal income of approximately 8%. If we assume further that real income grows by 4%, inflation would accelerate to 4% per annum.

This preoccupation with reaccelerating money velocity has begun to surface in the study departments of at least two Federal Reserve banks, Richmond and Cleveland. Using a broader measure of money, they have pointed out that after shifting upwards for a number of quarters (2Q1990 - 4Q1993), the trend of M2 velocity has resumed a rate more consistent with historical relationship to opportunity cost (see Chart 2). They then express alarm at the fact that M2 has been growing at or above 5% and dismiss those who argue that advances in technology are likely to spawn innovations that will induce future upward — and unpredictable — shifts in M2 velocity. If anything, they argue in the November 1997 *Economic Commentary* that the "nature of these shifts should accentuate a potential concern about persistent accelerations in M2. Moreover some analysts have argued that given recent advances in technology, we might expect a permanent increase in the velocity trend, perhaps in excess of 1%. If so, trend M2 growth of 5% would support trend nominal income growth of 6% or more — a pace that may be inconsistent with maintaining our current low inflation rates."

Whether one uses narrow money (M1) or broad money (M2), increased velocity, at a time when the monetary aggregates are growing at the fastest pace in years, is becoming a serious problem.

Chart 1 — M1 Velocity



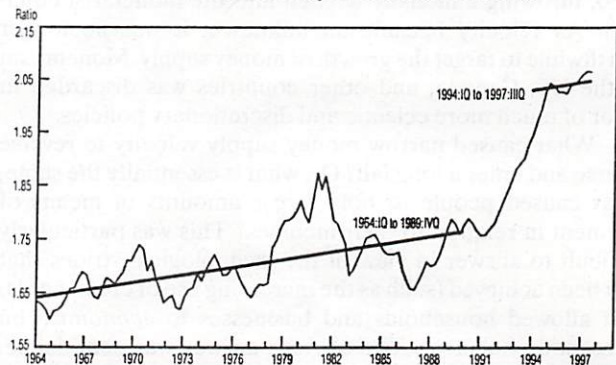
Concern as also begun to appear on the other side of the Atlantic about the rapid pace of broad money — especially in view of the fact that velocity may not continue to be as well behaved as it has been in the past. After stating that the 12-month growth rate of broad money was 11.6% in December, the Bank of England February 1998 *Inflation Report* notes that "broad money velocity has been below its long-run average since 1987 and has fallen further since 1995. This may be because of reduced opportunity cost of holding broad money, for example, because of lower inflation, as well as continuing financial innovation. Judgements need to be made about trends in velocity to interpret the relationship between broad money and nominal demand for use in inflation production. The Monetary Policy Committee's projection for inflation assumes that aggregate M4 velocity will decline gradually during the next two years...so long as broad money growth continues to slow. *But there remains a risk that the rapid and persistent monetary growth during the past two years will feed through to higher nominal demand and in turn into higher wages and prices.*" (Our emphasis.)

The use of aggregate M4 velocity is faulty in our opinion because this broad monetary aggregate is a better reflection of financial wealth than of transaction balances (a point to which they admit when attributing the decline in M4 velocity in recent years to the rise in the wealth/income ratio; see minutes of the MPC, page 53.)

In the November 1997 inflation report the Bank of England showed that the velocity of Divisia money (an index that weights the components of money according to their liquidity, proxied by the inverse of their relative interest rates), though behaving like M4 velocity, has tended to be more stable. Needless to say Divisia money is a closer approximation to transaction balances. The tentative conclusion thus is that in the UK, too, the beneficial effects of falling money velocity have run their course and a much stricter control of the explosive growth of the monetary aggregates will be necessary if a rekindling of inflation is to be avoided.

The rapid growth of the monetary aggregates in a number of major industrialized nations, in particular US, UK, Canada, and Japan, carries highly negative connotations for the financial markets, although the inflationary implications may not be felt for quite some months to come, given the Asian impact on commodity prices and manufacturers' margins. The period of stable to falling interest rates is almost at an end. Substantially higher interest rates are only a matter of time.

Chart 2 — M2 Velocity and Estimated Trends



SOURCES: U.S. Department of Commerce, Bureau of Economic Analysis; Board of Governors of the Federal Reserve System; and author's calculations.

Economic Commentary,
Federal Reserve Bank of Cleveland

CANADIAN DOLLAR**The Bank of Canada and the dollar**

These comments are based on a talk by Albert Friedberg to the C.D. Howe Institute on Feb. 21, 1998.

In the words of Shakespeare's Antony, "Lend me your ears; I have come to bury Caesar, not to praise him." But don't worry, Caesar stands for all central banks, not just the Bank of Canada. You might have guessed by now that I am opposed to the institution of central banking, and by implication I am in favor of free banking, but that is an entirely different discussion.

What about the Bank of Canada and the purchasing power of the Canadian dollar, of which it is in charge? Well, what about it? In February '91 the Bank of Canada and the Government of Canada jointly announced a series of targets for reducing inflation to the midpoint of a range of 1 to 3 per cent by the end of 1995. In December 1993, this target range was extended to the end of 1998. How has it done? Since early 1994, most measures of the CPI have fallen well within the self-imposed band; in fact, at 1.5%, core CPI has remained in the lower half of the inflation control target range.

That is, however, not as great an accomplishment as it seems (Chart 3). For one thing, 9 other industrialized countries out of 23 in our sample achieved lower inflation rates for 1997 than Canada, 6 of them without the putative benefit of explicit inflation targets; while 9 other countries recorded inflation rates of just under or just over 2%. Given the understandable imprecision of measuring consumer prices, a statistician, at least an amateur like myself, would be entitled to conclude that Canada's sterling inflation performance was not "statistically significant."

Nearly the entire industrialized world, for some as yet fully explained reason, has been enjoying an "inflation paradise."

Ironically, the US Federal Reserve, on whom so much praise has been lavished, has been one of the poorest performers: At 2.3%, the US inflation rate for last year was the fourth highest in the sample. David Johnson, in a paper presented to a conference organized by the Bank of Canada last spring, concluded that "while the credibility of monetary policy has increased with the move towards low rates of inflation [a global phenomenon as I have shown you earlier — my comment], it is difficult to draw firm conclusions as to whether explicit inflation targets have made any extra contribution to that effect." It is difficult indeed.

Let me return to my opening question. You will have noticed that I asked how the B of C performed with respect to the purchasing power of the Canadian dollar. I purposefully used the expression "purchasing power" rather than inflation, because purchasing power is a more inclusive — and relevant — term. Inflation is only one aspect of purchasing power — it is its internal manifestation. The foreign exchange value of the Canadian dollar is the external manifestation of its pur-

chasing power. Two sides of the same coin. In the short run, they rarely coincide. In the long run, they always do.

This is not the time and place to discuss this fascinating relationship, but take it in trust: Cheap money begets inflation in much the same way as inflation begets cheap money. It is not that one causes the other. Rather, both are caused by a permissive and lax monetary policy that allows the supply of money and credit to grow well beyond the demand or need for it. We can now appreciate the dismal failure of the new monetary policy. Since March 1991 the Canadian dollar lost 18.2 % of its external purchasing power, measured against a basket of the currencies of its main trading partners, and 20% against the US dollar. Incidentally, even if you don't accept my statement that the two aspects of purchasing power converge in the long run — and there is a wealth of empirical evidence to demonstrate it — you will concede that travelling abroad has become a great deal more expensive in recent years — a considerable loss of welfare, if you are a frequent traveler. Officials of the B of C are not about to tell Canadians to stay home because its monetary policy is only home-made, are they?

The problem

The B of C monetary policy, like that of almost all central banks, is discretionary. It bases policy — in its own words — "on a forward looking view of the evolution of the economy and its judgement about the impact of short-term interest rates and the exchange rate on spending. The path of spending expected in consequence is one that meets the inflation reduction goals of Canadian monetary policy" (taken from "The implementation of monetary policy in Canada" by Bruce Montador).

Let's take it in parts. It is forward looking, that is, it is based on divining the future. In this respect, it is not much different than the production quotas of consumer goods set by the planners in the old socialist states. They too guessed that consumers would need 20 million pairs of shoes and 5 million hats. Since the select group of sometimes very well-informed planners always miscalculated, socialist states suffered from chronic under- and over-production, leading to wrenching shortages and wasteful surpluses. As Ludwig von Mises already demonstrated back, if I recall, in the '20s, socialist planners could never be as intelligent as the millions of profit-maximizing producers and consumers responding to price signals — the invisible hand. Why would our senior central bankers, as intelligent and well informed as they are, be any better in manufacturing the right amount of money than the planners of the old socialist states were in ordering quotas of consumer goods? And if they are not, as we suppose, they are likely to continue causing exhilarating booms and painful busts.

Next we note their emphasis on the evolution of the economy, the impact on spending, and the path of spending. But, we ask, what does spending and the economy have to do with inflation? We have seen major depressions accompanied by rapid double-digit inflation (Mexico in 1995, after the devaluation, and many other South American countries in the early '80s), and we have read about the US economic boom of the last third of the last century, accompanied by mild deflation.

Rapid growth, unless accompanied by rapid credit growth, need not translate into inflation. Conversely, falling economic activity need not result in price moderation. Only too little or too much money — relative to its demand — influences prices. One suspects that the B of C knows this too, but that its hands are tied because it does not enjoy a clear-cut, single objective mandate of keeping inflation under wraps. Anyone who bothers to read the frequent speeches of the Governor in turn detects the Bank's almost obsessive preoccupation with economic activity.

Interestingly, the Reserve Bank of New Zealand, the first central bank to announce explicit inflation targets, is not burdened with this second mandate and is able to set policy in complete disregard of the pace of economic activity. Canada's inflation control strategy is flawed.

One final word about the Bank's present monetary policy. In its Inflation Control Strategy manifesto, the Bank states that "it uses its influence on short-term interest rates to achieve a rate of monetary expansion consistent with the inflation control target range." The Bank abandoned monetarism in the '80s, after acknowledging that the relationship between money supply and income had become too unstable and unpredictable, possibly because of technological innovation in the means of payment. Yet, the manifesto states that the Bank "strives to achieve a rate of monetary expansion [read: growth of money] consistent with the inflation control target range." If they abandoned money supply targets because these did not provide a dependable relationship with aggregate spending and inflation, what kind of rate of monetary expansion are they seeking now? Confusion, or merely double talk?

The truth of the matter is that the B of C, like almost all central banks, is navigating in the dark, without a compass. The tragedy is that the passengers are you and I.

What should the B of C do now? I was given just 10 minutes to speak and I have long used them up. But what good is it to bury the king and not to enthrone a new one?

Let me suggest very briefly two monetary regimes. The first, and simplest one, is to go back to a fixed rate, vis à vis the US dollar, hopefully at a slightly higher rate — one closer to long-term purchasing power calculations. Whether we choose 80 or 85 cents is not as important as the fact that we give up our right once and for all use discretion in the conduct of monetary policy. Fixing our exchange rate to the US dollar, as we did in the '50s and '60s, entails a loss of an independent monetary policy. So be it. In the long run, we are guaranteed to lose less purchasing power, given the much greater economic weight of our Southern trading partner.

A second, more novel, and admittedly more experimental approach would eliminate the need for the Bank to assess the economic situation, to project paths of spending, and to strive for a specific rate of monetary expansion before setting interest rates.

Taking a leaf from the writings of the great Swedish economist Knut Wicksell, who attributed inflation and deflation to the gap between a notional but very real natural rate of interest rate and the market rate, and making the daring assumption that long rates are the closest approximations to the natural rate, we would recommend that the Bank of Canada automatically set its Bank Rate one quarter percentage point above the 10-year Canada. In this way, the gap between the market rate (an assortment of the overnight rate, short-term money market rates, and commercial banks' lending rate) and the natural rate will close and monetary imbalances will hopefully disappear. In effect, the level of interest rates would be set by millions of market participants — and not a select group of planners. Understandably, the yield curve will tend to stay relatively flat.

Let me conclude with the response of Caesar: "He is a dreamer; let us leave him. Pass."

Chart 3

**Consumer Prices y-o-y
Industrial Countries 1997**

	%		%
AUSTRALIA	0.20	BELGIUM	1.60
SWITZERLAND	0.52	ITALY	1.60
SWEDEN	1.10	JAPAN	1.70
NEW ZEALAND	1.20	GERMANY	1.75
FRANCE	1.20	ICELAND	1.75
FINLAND	1.30	SPAIN	2.00
AUSTRIA	1.40	DENMARK	2.10
LUXEMBOURG	1.40	NETHERLANDS	2.10
IRELAND	1.45	PORTUGAL	2.10
CANADA	1.50	UNITED STATES	2.34
		NORWAY	2.58
		UNITED KINGDOM	3.20
		GREECE	5.30

S&P 500

Raging bull

Exhibiting a resilience comparable only to the nine lives of a cat, US stock prices ignored all the "bad" news and concentrated on the positive: a benign monetary environment and a stay of execution for perhaps another quarter for corporate earnings.

Leadership remains relatively narrow, because there is only enough money to chase and lift the big generals: mutual fund inflows have fallen below last year's levels, IPOs, option exercises, and secondaries have been absorbing more money than equity buy-backs, and M&A activity has increasingly been done in exchange for paper rather than cash. Narrowing leadership is also apparent on a more global basis: Only the US and a handful of European markets are making new highs.

All emerging markets are in one stage or another of bear trends. Even emerging market debt, in the past so quick to follow on the footsteps of the S&P has now fallen well behind, with spreads against Treasuries remaining 150 basis points above their October lows. This phenomenon vindicates our thesis that rational investors will emphasize liquidity in late stages of bull market *because they want to minimize exit costs*. (See "The futile search for underevaluation" in our February 1997 issue). At the time, we drew the conclusion that "those who insist on playing right to the end ought to concentrate on the most liquid securities, even when they are the most overvalued ones." Forget chasing bargains in Moscow, Bangkok, or São Paulo. If you are courageous enough to play the game, stick with Intel, Microsoft, and Dell.

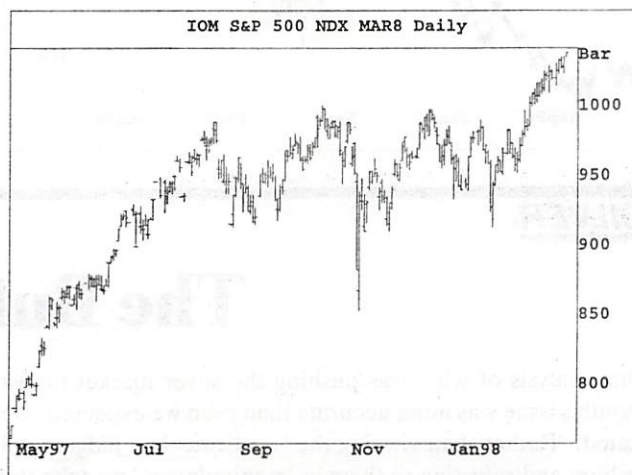
It is by now painfully obvious (to mauled bears like us) that the US bull market will not be aborted by a minor

economic slowdown, particularly those caused by exogenous factors nor by well advertised earnings reductions nor even by a war. It will take nothing less than a money-tightening cycle culminating in a consumer-led depression. Our opening comments make what we believe is a convincing case for tighter money somewhere in the not too distant future.

In the meantime, we'll keep our heads down, our powder dry, and we won't fire until we see the whites of their eyes.

STRATEGY: *Stopped out at 8150, basis March '98 Dow Jones Futures as per Hotline Update of Jan. 30. Stand aside.*

Chart 4 — S&P 500 Index

**JAPAN**

Reflating Japan

As expected, the Diet passed two measures providing ¥30 trillion (\$240 billion) in public money to stabilize the financial system. The Financial System Stabilization Law will allow the Resolution and Collection Bank to buy up to ¥13 trillion in preferred stock and subordinated bank bonds. The revised Deposit Insurance Law will allow the injection of ¥17 trillion to protect the deposits of failed financial institutions by providing funds to institutions that take over responsibility for the deposits.

The first measure is not likely to be implemented anytime soon: The larger banks do not need it or want it; other money center banks that actually need the capital injection are likely to cause a public outcry if they take it, because they have been tainted in the recent bribery scandal (paying offi-

cial at the BOJ to circumvent regulation and inspections); and a host of smaller banks are not likely to qualify very easily. In general, banks receiving funds could be required to remove incumbent management, a step that will not be taken too lightly.

The second measure is far more constructive; it is hoped that it will ease the way for great many insolvent banks to close their doors. With these not-quite-perfect measures, the government has forestalled the possibility of a run on the banks and a full blown financial crisis.

At the same time, and while fiscal policy remains mired in the indecisiveness, incoherence, and ineffectualness of the ruling party's politicians, the BOJ has finally kick-started a significant deflation. Excess reserves in recent weeks have

soared (see Chart 6), prompting an acceleration of bank credit. January's M2 plus CD year-on-year increase at 4.3% has broken out on the upside of its multi-year range and may yet succeed in reinvigorating the stalled economy.

In fact, Japan has joined the happy group of the money printers. The monetary asymmetry that lies at the heart of a modern central bank is evident for all to see: It is a lot easier

to ease than to tighten. *Ergo*, inflation will always be a greater threat than deflation.

STRATEGY: *The yen should once again come under pressure, weakened by a super-accommodative central bank and Japan's need to export its way out of a recession. Stay short as per Hotline Update of Feb. 17. Place stops at 8198, basis March '98.*

Chart 5 — Japanese Yen

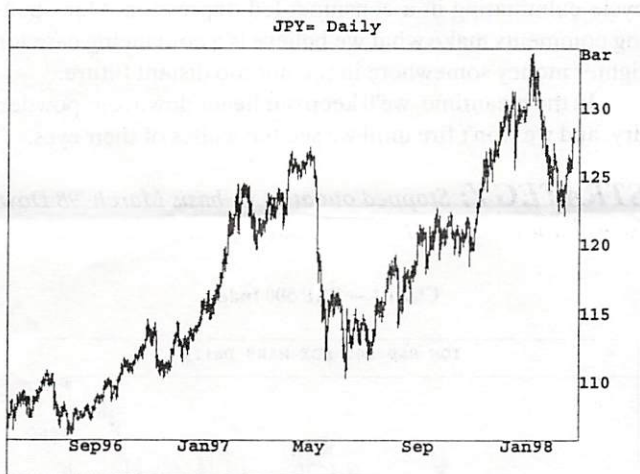
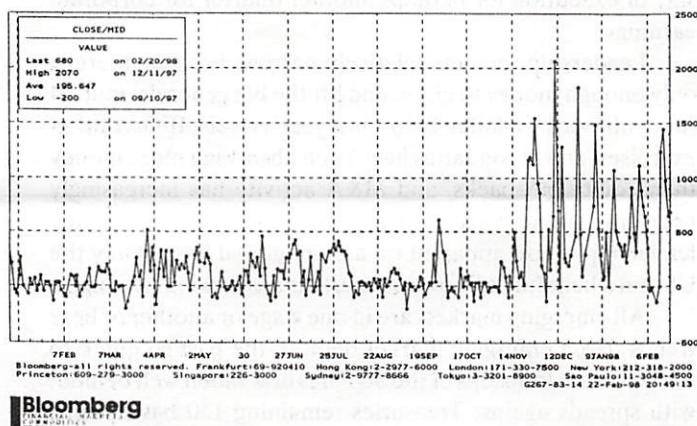


Chart 6 — Japanese Bank Excess Reserves



SILVER

The Buffett factor

Our analysis of what was pushing the silver market in last month's issue was more accurate than even we expected. We stated, "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."

Enter one Warren Buffet, value investor extraordinaire, hardly a syndicate. And who would dare call the master stock picker a "manipulator." In the Berkshire Hathaway Inc. press release of Feb. 3, Mr. Buffett's motivation for the 129.7 million-ounce shopping spree was explained as being deeply rooted in supply/demand fundamentals. The release states in part "...bullion inventories have fallen very materially, because of an excess of user-demand over mine production... equilibrium between supply and demand was only likely to be established by a somewhat higher price." So while we feel comfortable being on side with the guru's guru, we must examine what buying power is left to make this market go higher.

Unlike a syndicate that buys a commodity with the hope of using its collective financial power to keep supply off the market and engineer part of the tightness, Mr. Buffett's participation is complete.

Although he took a huge chunk off the market, 20% of available supplies, the effect of his buying power is no longer a factor, as he will likely buy no more. The press release was

clear about this: "Berkshire has no present plans for purchase or sale of silver." Others would have to pick up where Mr. Buffett left off. Last week there was talk in the market that a man who is no stranger to taking large positions in hot markets was sniffing around the silver centres: Mr. George Soros.

One important test for the bull side has shown shaky results early in the game. The surge in prices that resulted after all that silver was taken off the market should ultimately bring supplies to the market, creating the equilibrium that Berkshire speaks of. India, with close to a billion people, has long been the world's great importer of silver. So when we hear that Indian buying has been drying up, we know that the Indian consumer/investor is being quite price sensitive. After Indian imports in the early part of 1997 were running at about 300 tonnes per month, the last few months of the year saw imports of only 150 tonnes per month. Analysts say that the price would have to be considerably higher to turn them into net sellers, but this quick response is, for the moment, disquieting.

There is evidence that the tightness has eased. Lease rates have fallen to 15% after skyrocketing to as high as 70% in recent weeks. Although still dramatically low, COMEX warehouses that were emptied by Mr. Buffett showed the first significant increase in as long as anyone can remember this past Friday, jumping by almost 2 million ounces.

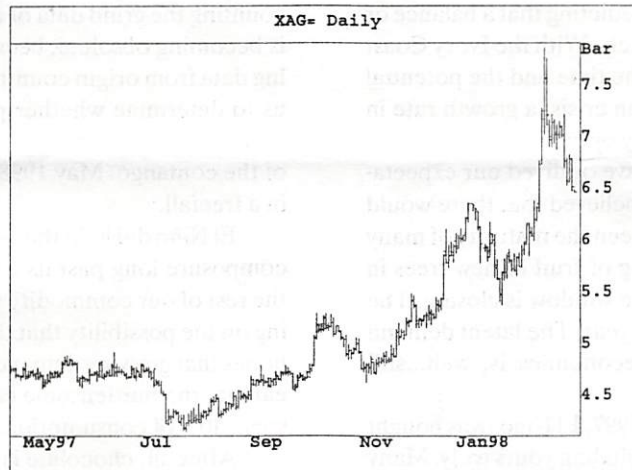
The good news in the fundamentals camp is that despite some fear that computer imaging will put a dent in silver consumption, the numbers from the photography industry show otherwise. According to an industry group, the use of silver in photography rose 1.4% in 1996 and a further 3% in 1997.

Last week's little dip was quite uncomfortable. However, looking beyond the very distasteful experience of watching profits disappear, there are some constructive signs. First, it is not uncommon for major breakouts to be tested by coming

back to the point of the breakout. Although we would find it difficult to explain exactly why this happens, a glance at Chart 7 shows that this is precisely what has happened since silver bottomed in the summer of 1997. The open interest has been fairly well behaved. It peaked at just under 114,000 contracts, which is not excessive when compared with some other bull runs in silver. In this correction the market has shed about 4,000 contracts. We remain bullish, but nimble.

— Sholom Sanik

Chart 7 – Silver



COPPER

The comfy bear

Not much has changed in the copper market. Supplies are growing. Demand is waning. Prices keep sliding.

In Chile, the beat goes on. The Chilean government's National Statistics Institute reported the final numbers for 1997. They showed production of 3.435 million tonnes, which was up 9.27% over 1996's record output of 3.144. And nobody is talking cutback. One analyst estimated that Chilean output would rise by 12.9% in 1998.

The closing of mines is a long, slow process. Most miners are still making money. Technology has been moving as fast as in any other industry, the cost of production has been inching downward and with it the price per pound that would force mine closures. Smelters in China and Russia will stay open longer than they should, because they are controlled by the state and are large employers, efficient or not. Asarco has stated publicly that its production costs are still below spot prices and that it has no plans for shutting mines.

Although dwarfed by Chile, the activity in the copper mining industry in Mexico is typical of what is happening in the copper market. Huge investments in copper mines are paying off in tremendously efficient operations. Grupo Mexico, which produces over 90% of Mexico's total output of just over 400,000 tonnes, has seen its production rise this year by over

20%. What's even more interesting is that its production costs are among the lowest in the world at an average price of 45¢ per pound compared with the average world price of production of about 60¢ per pound. It has ample room to make money on its operations. No reason for it to shut anything down.

The cancelled infrastructure projects in Indonesia are just the tip of the iceberg. Some analysts predict that it will be the year 2000 before the battered and bruised Asian economies have turned themselves around enough to become significant buyers again. The countless millions of dollars of investments that were poured into copper mines were actually chasing these customers of the Asian economic miracle. It is true that many of these countries have been pushed so low that they are actually in the process of a healthy restructuring process. However, it will take time before they can be counted on to eat up the excessive production.

The International Copper Study Group reports that the bottom line is a balance between refined production to consumption show, a surplus for 1997 of 393,000 tonnes for the first 11 months of 1997, compared with a deficit of 40,000 tonnes in 1996.

The bear is comfortable.

— Sholom Sanik

COCOA

Getting used to being short

The deficit story is old hat. Year after year of production/consumption deficits, and the contango is still alive and well. On Feb. 12 the ICCO forecasted a 1997-98 deficit of 145,000 tonnes. The market yawned and made yet another new low. In the days that followed, GNI and Merrill Lynch both challenged the ICCO deficit forecast, predicting that a balance or even a small surplus was far more likely. With the Ivory Coast crop looking better and better all the time and the potential for a curb in demand from the Asian crisis, a growth rate in consumption of 2.5% looked terribly optimistic.

The trees in the Ivory Coast have outlived our expectations for them. For a long time, we believed that there would be a period of a couple of years between the maturity of many trees in West Africa and the bearing of fruit of new trees in Southeast Asia. But it seems that the window is closing. The Ivory Coast's crop gets bigger every year. The latent demand from the emerging Third World economies is, well...still latent.

The great commodity story of 1997, El Niño, was bought enthusiastically by many traders, including yours truly. Many months and 30,000 contracts of open interest later we find that El Niño might have had a significant impact on the weather in New York City, but it surely had nothing to do with cocoa plants in West Africa.

Another bearish factor overhanging this market is that Phibro has long been rumored to be holding a significant chunk of beans off the market in hope of unloading them at

higher prices. Word on the street has it that they are ready to throw in the towel and have 500,000 tonnes to dump. That's lots of cocoa.

As we've pointed out before, the traditional, and rather unique, method of counting consumption of cocoa, that is, counting the grind data of the four largest grinding countries, is becoming obsolete, because it does not account for grinding data from origin countries. The most efficient method for us to determine whether price movements are reflective of desperate/passive buying/selling must then be the behavior of the contango. May 1998 against May 1999 (see Chart 8) is in a freefall.

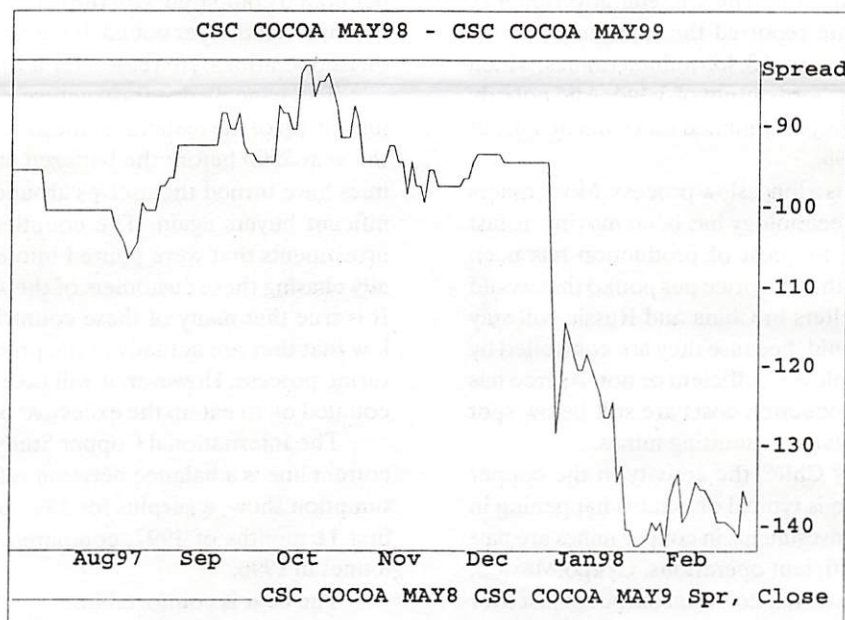
El Niño did help the price of this commodity maintain its composure long past its due. It has now joined the ranks of the rest of our commodity markets. Its traders are now focusing on the possibility that the Asian crisis has jeopardized the hopes that growing demand from the Third World would help eat into the burdensome carryover stocks that still represent some 40% of consumption.

After all, chocolate is still a luxury item in these emerging nations. The rising disposable income that we had hoped would be used to buy these Western treats has taken a step backwards.

We're not all that accustomed to being short cocoa, but we're getting used to it.

— Sholom Sanik

Chart 8 – Cocoa



SOY COMPLEX**Buying opportunity in the making**

The soybean market enjoyed a bull market that spanned two and a half years on the calendar and three and a half dollars on the charts. The bull was led by voracious demand for protein meal that is used to feed hogs and chickens. The liberalizing economies of the 1990s were spawning consumers that were scrambling to catch up to their counterparts in the West. Eating habits were changing, and meat was rapidly becoming a staple in the diets of the newly hatched cultures. The ever-efficient free marketplace responded with record crops in the US and South America. The market has shaved two and a half of those three and a half dollars off the charts since last spring.

Spot soybean prices are most definitely in a downtrend. The basic fundamentals support this, because both the supply (record crops) and demand (curtailment of Asian demand) sides are negative. Yet the lows in this market were set months ago. As the full impact of the Asian crisis was being digested and the region's currencies — and the buying power they represent — were being crushed, this market was actually stabilizing. Besides, from a historical perspective, current prices of between \$6.50 and \$7.00 per bushel are still quite rich. One could argue that prices are merely on their way down. On the other hand, one could support an argument that the few commodities whose prices have not crumbled completely are telling us something.

The soybean market is in a state of flux. There is a tug-of-war. On the one side, the powerful bull market was carried by demand for soybean meal. All agree, including us, that the Asian Tiger countries will not be able to maintain the pace of their buying. However, at the same time, the dynamics of the vegetable oil market have changed. The demand for soybean oil has kept soybean prices from plummeting.

The most immediate concern in the soybean oil market is the sudden loss of availability of palm oil supplies, which ironically is being caused by the same turmoil that has killed demand for soybean meal. Indonesia and Malaysia together produce about 80% of the world's palm oil. Palm oil is the second largest vegetable oil in the world in production, but is the leader in exports. So, when Indonesia bans exports for three months, there is, understandably, a shortage in the making. We consider this particular part of the crisis to be temporary. Palm oil doesn't store well, and the Indonesians will more than likely grant export licenses rather than allow it to go bad.

The ban is politically motivated, because Indonesia produces more than enough to feed the domestic market with plenty left for export. According to the USDA, in 1997-98 Indonesia will produce 5.4 million tonnes of palm oil and will need only 3.2 million tonnes for domestic consumption. As soon as it does release supplies, the soybean oil market will certainly use it as an excuse to correct a market that has been making new highs and collecting an arsenal of speculators that will let go at the first sign of trouble.

The information that is available to us to gauge how much tightness this has brought to the soybean oil market is not that convincing. First, the March/May contango has actually widened. If the Indonesian export ban was indeed sending buyers to the US, this spread would have tightened. Then, export commitments have been dwindling. Save for this past week, the commitments have been coming in below trade expectations and at numbers that would not support the USDA's estimate for US exports of 2.5 billion pounds.

The big picture, however, makes more sense of the recent stride in soybean oil prices and their departure from the direction of soybean meal prices. According to the USDA, consumption of vegetable oil has grown much faster than production in recent years. In the past 5 years consumption amongst the largest importing countries has grown by almost 40%, while production in the largest exporting countries has grown by about 20%. Further, while the Asian Tigers with the biggest financial headaches are big importers of protein meal, we needn't worry about their demand for soybean oil, because they were never our customers in the first place. Rather, Europeans who have been the traditional big buyers of palm oil may turn to soybean oil as an alternate and more reliable source for their vegetable oil needs.

Again, we point out the vulnerability of this market to a sudden announcement from the Indonesian government that the export ban is over. The future, though, may hold promise for strong support for soybean prices and a possible bull market for soybean oil.

STRATEGY: *A sharp drop resulting from the lifting of the Indonesian export ban could be viewed as a buying opportunity. Stay tuned.*

— Sholom Sanik

Chart 10 – FOREIGN CURRENCY BONDS

DATE: February 20, 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	
DEUTSCHE MARK DENOMINATED BONDS						
World Bank 7 1/4% 13/10/99 RRSP eligible	104.45	105.30	3.83		Oct-13	
World Bank 9% 13/11/00 RRSP eligible	111.50	-	-		Nov-13	
Argentina 8% 5/10/98	100.75	-	-		Oct-05	
Kgdm. of Spain (6 Mo. LIBOR-1/16) 29/6/02 (semi)	99.85	100.15	-	3.75	Jun-29	
CZECH REPUBLIC KORUNA BONDS						
General Electric Cap. Corp. 10.5% 23/10/98	95.45	-	-		Oct-23	
Nordic Inves. Bk 10.625% 10/11/00	89.80	-	-		Nov-10	
SWISS FRANC DENOMINATED BONDS						
General Electric Cap. Corp. 4 3/4% 2/7/98	100.40	-	-		Jul-02	
General Electric Cap. Corp. 4 1/2% 17/12/99	104.60	-	-		Dec-17	
DANISH KRONE DENOMINATED BONDS						
Kgdm. of Denmark 9% 15/11/98	102.85	103.70	3.67		Nov-15	
ECU DENOMINATED BONDS						
United Kingdom 9 1/8% 21/02/01	112.40	113.25	4.31		Feb-21	
BRITISH POUND DENOMINATED BONDS						
European Inv. Bk. 7% 22/12/98	99.05	99.90	7.04		Dec-22	
Kgdm. of Denmark FRN 28/8/98 3mo LIBOR-12.5b.p.(qly)	99.65	-	-	7.625	Feb-27	
CANADIAN DOLLAR DENOMINATED BONDS						
Ontario Province 10 5/8% 15/7/98 RRSP eligible	101.35	102.60	3.61		Jul-15	
Petromet Resources 6.5% 31/3/04 (semi) CV @ \$9.50 p/sh	90.25	-	-		Mar-31	
SOUTH AFRICAN RAND DENOMINATED BONDS						
ESCOM 11% 1/6/08 (semi)	85.25	86.75	13.41		Jun-01	
AUSTRALIAN DOLLAR DENOMINATED BONDS						
Toronto Dominion Bk. Aust. 7.25% 26/2/99 RRSP eligible	102.10	102.95	4.20		Feb-26	
NEW ZEALAND DOLLAR DENOMINATED BONDS						
World Bank 8.25% 30/4/99 RRSP eligible	98.90	99.75	8.43		Apr-30	
New Zealand Gov't 8% 15/7/98 (semi)	99.15	100.00	7.99		Jan-15	
Ontario Province 7.15% 24/11/98 (semi)	98.40	-	-		May-24	
Fletcher Challenge 10.15% 30/11/98 CV (semi)	99.45	100.30	9.69		May-31	
Tranz Rail Ltd. 10% 15/10/99 (semi)	100.30	101.15	9.21		Apr-15	
Trans Tasman 9% 27/6/99 CV (semi)	88.90	89.75	17.91		Jun-26	
St. Luke 8.7% 1/4/99 (semi) CV @ 1.00 p/sh	146.25	-	-		Apr-01	
Kiwi Income Prop. Trust 9% 30/9/03 CV (semi)	117.10	119.10	9.22		Mar-31	
ARGENTINEAN PESO DENOMINATED BONDS						
Bocon Pre 1: 1/4/2001		<u>PAR VALUE</u> 109.6875		<u>IRR</u> 11.12	Mar-01-98	
U.S. DOLLAR DENOMINATED FIXED CONV. BONDS						
Coeur D'Alene 6% 10/6/02 CV@ 26.00 p/sh	73.25	74.75	14.22		Jun-10	
JumboSports 4 1/4% (semi) 11/1/00 CV @ 25.5 p/sh	41.25	-	-		May-01	
The Learning Co. 5 1/2% (semi) 11/1/00 CV @ \$53.00 p/sh	88.35	89.85	9.89		May-01	
Novacare Inc. 5.5% (semi) 15/1/00 CV @ \$26.65 p/sh	94.30	95.80	7.92		Jan-15	
U.S. DOLLAR DENOMINATED FIXED RATE BONDS						
U.S. Treasury 6.25% (semi) 28/2/02	102.50	102.80	5.46		Feb-28	
U.S. Treasury 6.375% (semi) 15/8/27	106.65	107.25	5.86		Feb-15	
U.S. Treasury Coupon Strips 0% 15/2/25	20.45	20.75	5.91		Feb-15-25	
U.S. Treasury Principal Strips 0% 15/2/25	20.45	20.75	5.91		Feb-15-25	
World Bank 7 1/8% 27/9/99 (semi) RRSP eligible	102.15	103.00	5.13		Mar-27	
Mobile Telecomm 13.5% (semi) 15/12/02	117.10	117.95	8.82		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	99.75	100.05	-	5.3750	May-13	
Bocon 1/4/01 (30 day LIBOR) starts paying May 1, '97	PAR: 105.1928	99.75	-	-	Mar-01-98	
Argentina: Series L:FRB 31/3/05, 6 mo. LIBOR+13/16 (semi)	PAR: 96	89.55	91.05	9.24	6.6875	Mar-31
Venezuela: DCB: 18/12/07, 1 mo. LIBOR+7/8 (semi)	PAR: 95.2381	88.25	-	-	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.
Updated bond prices available on the Internet at: http://www.friedberg.com/bond_prices.html

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

1. US Treasury Strips 0% '25 (US\$)	25%	4. US Treasury 6.25% '02 (US\$)	22.5%
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%

HOTLINE UPDATE**Tuesday, January 13, 1998:**

Good afternoon for Tuesday, January 13. There are no changes or new recommendations.

Thursday, January 15, 1998:

Good morning for Thursday, January 15, 9:00 am. This is a Flash Update. Sell short March copper at the market, presently trading at .7675, placing initial stops at .8200, good anytime.

Friday, January 16, 1998:

Good afternoon for Friday, January 16. There are no changes or new recommendations. The following is a recap of this week's recommendations.

- On Thursday, January 15, via Flash Update, we advised selling short March copper at the market, then trading at .7675, placing initial stops at .8200, good anytime.

Flash Update: Wednesday, January 21, 1998:

Good afternoon for Wednesday, January 21, 12:10 pm. This is a Flash Update. Cover short March Canadian dollars at the market, presently trading at .6935.

Flash Update: Wednesday, January 21, 1998:

Good afternoon for Wednesday, January 21, 5:30 pm. This is a Flash Update. Liquidate short March Japanese yen and short yen call options at the market. We repeat the flash Update of this morning to cover short March Canadian dollars at the market, then trading at .6935.

Flash Update: Thursday, January 22, 1998:

Good afternoon for Thursday, January 22, 5:30 pm. This is a Flash Update. We have 2 new recommendations. 1) Sell short March Canadian-90 day bankers acceptance notes, traded on the Montreal Exchange, at the market; and 2) change stops on short gold to 298.10, basis April, good anytime.

Friday, January 23, 1998:

Good afternoon for Friday, January 23. There are no changes or new recommendations. The following is a recap of this week's recommendations.

- On Wednesday, January 21, via Flash Update, we advised covering short March Canadian dollars at the market, then trading at .6935 and to liquidate short March Japanese yen and short yen call options at the market. On Thursday, March yen opened at .7942.
- On Thursday, January 22, via Flash Update, we advised selling short March Canadian 90-day bankers acceptance, traded on the Montreal Exchange, at the market and to change stops on short gold to 298.10, basis April, good anytime. This morning, BA's opened at 95.23.

- A reader has kindly pointed out a typographical error in our latest newsletter of January 11/98. On page 6, in the 5th paragraph, on the right side it reads, "The view that we may be entering a period of price inflation is gaining ascendancy...". It should read "price **deflation** is gaining ascendancy..."

Tuesday, January 27, 1998:

Good afternoon for Tuesday, January 27. We have one new recommendation. Sell March JGB 10-year Japanese bonds, traded on the SIMEX or Tokyo Stock Exchange, at the market.

Flash Update: Friday, January 30, 1998:

Good morning for Friday, January 30, 9:15 am. This is a Flash Update. Sell May cocoa at the market, presently trading at 1616, placing initial stops at 1683, good anytime.

Friday, January 30, 1998:

Good afternoon for Friday, January 30. We have one new recommendation. Lower stops on short Dow Jones to 8150, close only, from 8270. The following is a recap of this week's recommendations.

- On Tuesday, January 27, we recommended selling March JGB 10-year Japanese bonds, traded on the SIMEX or Tokyo Stock Exchange, at the market. The March JGB opened on Wednesday at 128.08.
- We repeat the Flash Update of this morning, to sell May cocoa at the market, then trading at 1616, placing initial stops at 1683, good anytime.

Flash Update: Monday, February 2, 1998:

Good afternoon for Monday, February 2, 5:00 pm. This is a Flash Update. We have two new recommendations. Cover March Banker's Acceptance at the market, and buy May silver at the market, placing initial stops at 5.40, good anytime. One clarification: The stop on short Dow Jones is 8150, basis March, close only.

Flash Update: Friday, February 6, 1998:

Good morning for Friday, February 6, 8:20 am. This is a Flash Update. Sell March Canadian dollars at the market, presently trading at 6990.

Friday, February 6, 1998:

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

- On Monday, February 2, via Flash Update, we advised covering March Banker's Acceptance at the market and to buy May silver at the market, placing initial stops at 5.40, good anytime. On Tuesday, March Banker's Acceptance opened at 94.82 and May silver opened at 621.00.

HOTLINE UPDATE

- We repeat the flash update of this morning advising selling March Canadian dollars at the market, then trading at 6990.

Tuesday, February 10, 1998:

Good afternoon for Tuesday, February 10. We have one new recommendation. Place stops on short March Canadian dollars at 7055, close only.

Flash Update: Thursday, February 12, 1998:

Good afternoon for Thursday, February 12, 5:30 pm. This is a Flash Update. Buy May sugar at the market, placing stops at 10.32, good anytime.

Friday, February 13, 1998:

Good afternoon for Friday, February 13. There are no changes or new recommendations. The following is a recap of this week's recommendations.

- On Tuesday, February 10, we recommended placing stops on short March Canadian dollars at 7055, close only.
- On Thursday, February 12, via Flash Update, we advised buying May sugar at the market, placing stops at 10.32, good anytime. This morning May sugar opened at 10.75.

Flash Update: Tuesday, February 17, 1998:

Good morning for Tuesday, February 17, 8:45 am. This is a Flash Update. Sell March Japanese yen at the market, presently trading at 7962.

Tuesday, February 17, 1998:

Good afternoon for Tuesday, February 17. We have two new recommendations. Cover short March JGB at the market. And, place stops on short March Japanese yen at .8195, good anytime.

Friday, February 20, 1998:

Good afternoon for Friday, February 20. We have one new recommendation. Lower stops on short May cocoa to 1630, good anytime. This is a complete summary since our last market letter dated January 11, of all liquidations of open positions and new recommendations that remain outstanding.

- On Thursday, January 15, via Flash Update, we advised selling short March copper at the market, then trading at .7675, placing initial stops at .8200, good anytime.
- On Wednesday, January 21, via Flash Update, we advised covering short March Canadian dollars at the market, then trading at .6935 AND liquidating short March Japanese yen and short yen call options at the market. On Thursday, March yen opened at .7942.
- On Thursday, January 22, via Flash Update, we advised changing stops on short gold to 298.10, basis April, good anytime.
- On Friday, January 30, via Flash Update, we advised selling May cocoa at the market, then trading at 1616, placing initial stops at 1683, good anytime AND to lower stops on short March Dow Jones to 8150, close only, from 8270.
- On Monday, February 2, via Flash Update, we advised buying May silver at the market, placing initial stops at 5.40, good anytime. On Tuesday, May silver opened at 621.00.
- On Friday, February 6, via Flash Update, we advised selling March Canadian dollars at the market, then trading at 6990.
- On Tuesday, February 10, we recommended placing stops on short March Canadian dollars at 7055, close only.
- On Tuesday, February 17, via Flash Update, we advised selling March Japanese yen at the market, then trading at 7962.

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