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Inflation risks: the Fed (and most everyone else) is in denial

Lost in the din of the extraordinary drama taking place at the corner of Wall and Broad Streets, a small and important piece of data released last week went unnoticed. It confirmed to us that inflation, sustained and accelerating inflation, is the coming plague (forget the Asian flu). As always, what is coming is what is least expected.

Granted that one ought not draw too many serious conclusions from reading one, two, or three months' economic data. Nevertheless, when these pieces of evidence contradict conventional expectations and instead fit into a more unconventional thesis, one ought to take notice. The data? Core consumer prices in the last 3 months have increased at an annualized rate of 2.8%, an acceleration from the average core inflation rate in 1997 of 2.4%.

There were, as there always is, some unusual factors. In fact, a reversal of the February increases in airline fares and tobacco prices and continued low oil prices could, once again, send core prices down. But, as friend Chris Iggo, the economist and data-watcher at BZW Securities points out, there are enough categories showing rising prices and enough industries having to deal with rising labor costs that the risk is biased towards a firming of inflation. Prices for services increased by 0.5% in February and are up 3.1% year-over-year, continuing the pattern of 1997, where goods-price inflation slowed to about 0.5%, while service-price inflation marked a 3% pace.

Why is this data so significant to us? Because it comes at a time that the Asian economic collapse has sent commodities prices into a freefall (see Chart 1) and because it comes at a time when Fed officials have expressed serious concerns about the possibility of deflation.

Accelerating inflation in the US is no small matter. It will frighten bondholders. In the face of enormous dealer leverage and speculative holdings (let alone trillions of notional dollars of derivatives), it could send interest rates soaring upwards. Rising interest rates will surely doom stock prices, which, in turn, could dramatically affect the real economy via the little-understood (for lack of historical experience) wealth effect. In short, every serious economist and investor must grapple with the outlook for prices and must find a way to anticipate correctly the march of inflation.

Years of relatively benign inflation — as much a product of rising productivity as perceptions that central banks can be trusted in the management of our money and, which, in turn, slowed down money velocity — have dulled our ability to recognize the signs of the scourge of fiat money regimes.

Last month we posited that the much maligned and ignored M1 velocity was flashing signs of danger: Its long-term decline had come to an end, responding to the continuous improvements in technology and increased consumer sophistication (the main components of M1 do not bear interest). Rising velocity (at an observed rate of 6%-7% per annum!) made it imperative for the Fed to control the growth of this narrow aggregate. Over the past 6 months, M1 growth has turned positive, averaging roughly 1%-2% per annum, which in view of rising velocity, points to an unexpectedly strong advance in nominal GNP and an acceleration of inflation.

While our preference has been with M1 velocity, we noted the concern expressed by at least two Federal Reserve banks with M2 velocity. This concern has recently been heightened with the release of figures that show M2 growing at an extraordinary pace of 8.6% over the past month and 7.3% over the past 6 months, well above the provisional ranges set by the monetary authorities as being consistent

In this issue

Contributions by Albert D. Friedberg and Sholom Sanik.

with price stability ("provided that these aggregates act in accord with their pre-1990 historical relationships with nominal income and interest rates," according to Alan Greenspan's recent testimony — see below).

Mr. Greenspan is aware of this problem and addressed it — or perhaps just dismissed it — in the Humphrey-Hawkins testimony to the House Banking committee last February 24. He said: "In the first part of the 1990's, money growth diverged from historical relationships with income and interest rates, in part as savers diversified into bond and stock mutual funds, which had become more readily available and whose returns were considerably more attractive than those on deposits. This anomalous behavior of velocity severely set back most analysts' confidence in the usefulness of M2 as an indicator of economic developments. In recent years, there have been tentative signs that the historical relationship linking the velocity of M2 (see Chart 2) — measured as the ratio of nominal GDP to the money stock — to the cost of holding M2 assets was reasserting itself. However, a persistent residual upward drift in velocity over the past few years and its apparent cessation very recently underscores our ongoing uncertainty about the stability of this relationship. The FOMC will continue to observe the evolution of the monetary and credit aggregates carefully, integrating information about these variables with a wide variety of other information in determining its policy stance."

Despite his admission that "there have been tentative signs that the historical relationship linking the velocity of M2 to the cost of holding M2 assets was reasserting itself," Greenspan chose to ignore the threat because "of our ongoing uncertainty about the stability of this relationship." If anything — given stable to slightly rising velocity coupled with strong money supply growth — the risks are clearly on the upside. Is he in denial because he is afraid to ruin the party?

Pretty much the same thing was echoed by other Fed officials. As reported by Reuters this past Friday, Edward Boehne, head of the Federal Reserve of Philadelphia, told reporters that he was not concerned about the rapid expansion of monetary aggregates in the US, especially the M2 gauge. "I think the growth of the money supply may reflect some excesses in credit [sic!]...(but) the precise growth number for M2 in and of itself does not bother me because there has been a fair amount of volatility (sic!) in those numbers in recent years," the Philadelphia Fed president said.

What does he mean with a "fair amount of volatility"? Is he saying that the rate of growth of M2 has fluctuated a great deal in the recent past, implying that it will soon return to its lower rate of growth, as it has done in the past? Has he seen a chart of M2 growth? Could the reader discern anything other than a steady uptrend in the rate of growth in M2 (Chart 3)? Double-talk or denial?

On the same day, Harvey Rosenblum, director of research at the Dallas Fed, told Reuters in an interview that "we have a slowing in the rate of growth, accompanied by a reduction of inflationary pressures" [*What is he watching?— ed.*]. He acknowledged that "the asset price inflation that we have seen in terms of financial assets may start spilling over to real estate assets and other kinds of markets...my biggest concern is that it not get out of hand and go too far. These are difficult things for monetary policy to deal with" [*Oh really. Are they not caused by monetary policy gone wild? — ed.*].

Yet, asked about the rapid rate of growth of M2, Rosenblum, a monetarist by training, replied that so far, he was not worried, but added "if it keeps it there for another 6 months, then I am going to start being concerned. As of right now, I think it is still too soon to get upset. My own feeling is that there is probably some redistribution of resources among financial institutions."

Perhaps Rosenblum did not notice that the monetary aggregate under the direct control of the Fed, the Adjusted Monetary Base — the stuff that supports money supply growth and whose effect can only be magnified by the redistribution of M1-type deposits to M2 type deposits — has also been growing at better than 7% per annum in the past 6 months. Double-talk, or denial?

For commodity watchers like ourselves, this posture may appear contradictory. After all, the dollar price of gold has plummeted, the energy-laden Goldman Sachs commodity index has lost 16% during the past year, while the agriculture-heavy Commodities Research Bureau Index has fallen 8%. And, as we noted earlier, the Journal of Commerce Industrial Index has dropped 12.4%.

How, then, can inflation accelerate? The answer, as we hinted earlier, is that goods inflation will remain subdued for quite some time yet, while service inflation accelerates. Overall inflation will accelerate slightly despite some sectoral weakness. At a later stage, goods-inflation will join service inflation, and inflationary pressures will pick up speed.

What is important to keep in mind is that consumer price inflation is affected primarily by the rate of change of commodity prices: When their decline accelerates (say, on a year-over-year basis) consumer prices, very shortly thereafter, slow down. Weak or falling commodity prices have little or no bearing on consumer prices as long as the rate of decline is not accelerating. In fact, falling commodity prices whose rate of decline has decreased tend to have an inflationary impact (when monetary conditions warrant it, of course) on overall consumer prices. A look back in history to a time that inflation accelerated and commodity prices were subdued will demonstrate this point.

Rapid fiscal and monetary stimulus in the second half of the '60s caused inflation to accelerate from 2.5% to almost 7%. Yet, this was a period characterized by relatively weak commodity prices. Now note on Chart 4 the impact of commodity prices on consumer prices: Despite a spectacular drop in commodity prices in 1966 and 1967, consumer prices only slow their upward climb. By mid-1967, commodity prices stabilize (although they are still down year on year for at least another half a year), and consumer price inflation accelerates.

We rest our case. Monetary conditions are sufficiently easy not only to cause an asset bubble, as we have been suggesting for well over one year, but also to embark us on a path of accelerating inflation. The battle to rein in the inflationary monster will burst the bubble and bring in its wake a painful and long recession.

STRATEGY: *It is no longer prudent to maintain positions in long-term, fixed-rate securities. Bond accounts are urged to shorten duration. Fortunately, the sacrifice in yields is remarkably small.*

Chart 1 — Journal of Commerce Industrial Index

Chart 2 — Velocity of M2

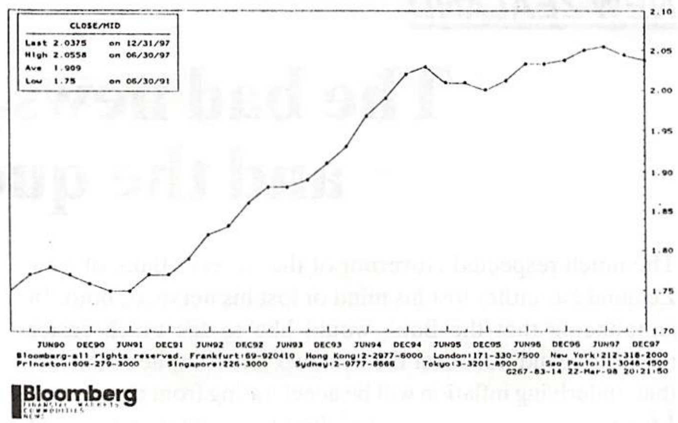


Chart 3 — M2 Year-on-Year % Changes

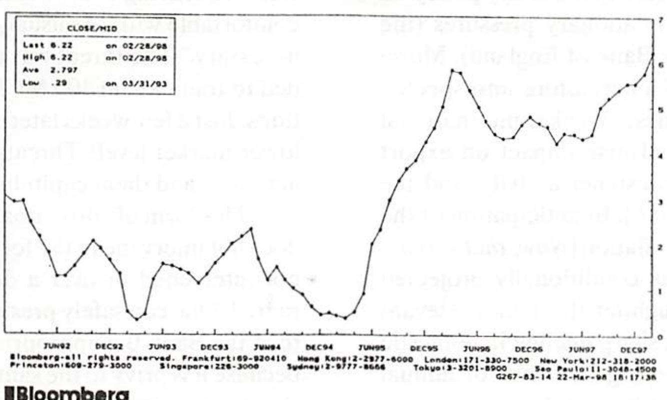
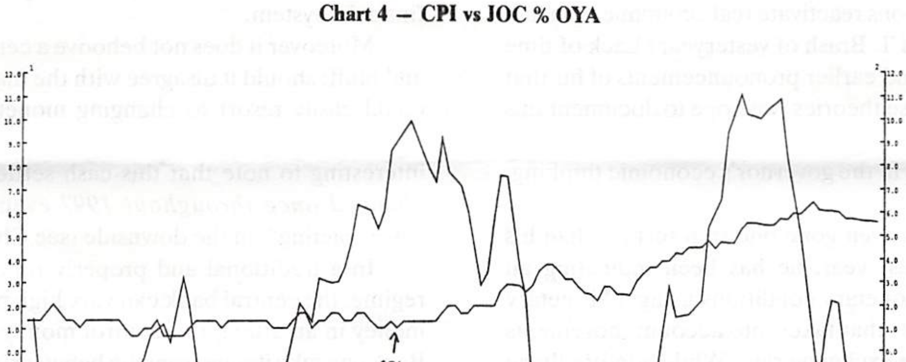


Chart 4 — CPI vs JOC % OYA



NEW ZEALAND

The bad news, the good news and the question mark

The much respected Governor of the Reserve Bank of New Zealand has either lost his mind or lost his nerve, or both. In announcing that the Bank would like to see much easier monetary conditions over the next two years in spite of the fact that underlying inflation will be accelerating from the present 1.6% to 2.1% in June 1998, he jolted the market and caused a shocking 2¢ overnight fall in the already-battered Kiwi.

In one fell swoop Mr. Brash joined the club of the those central bankers who base their stance of monetary policy on forward-looking assessments of inflationary pressures (the Fed, the Bank of Canada, and the Bank of England). Moreover, he, like they, demonstrated a heretofore unsuspected attachment to Keynesian economics: "Weaker international demand is expected to have an adverse impact on export activity, domestic business and consumer activity, and the terms of trade [*All of this true — ed.*]. In anticipation of the impact of these developments on inflation [*Now, that's something new! — ed.*], the Bank has conditionally projected easier monetary conditions throughout the policy-relevant horizon. This will act to prevent a sharp decline in domestic economic activity, while still keeping the level of annual consumer price inflation near the centre of the target range" [*that is, 1.0%-3.0% — ed.*].

Voilà. Weak demand translates into lower inflation. And easier monetary conditions reactivate real economic demand. Is this the same Donald T. Brash of yesteryear? Lack of time has not allowed us to find earlier pronouncements of his that very clearly disown these theories (we hope to document this in months to come), but it is quite clear that an important change has taken place in the governor's economic thinking. That's the bad news.

The Governor has even gone one step further than his colleagues. For the past year, he has been indicating an appropriate level for monetary conditions using a Monetary Conditions Index (MCI) that takes into account movements in interest rates and the exchange rate. While admittedly he does not *set* interest rates as his colleagues do, an argument can be made that he has become even more interventionist than his counterparts who do not express specific opinions about the appropriate level of future monetary conditions. The governor may view this aspect more charitably than we do, arguing that the Reserve Bank is, for that matter, a more transparent institution. For all that welcome transparency, though, the Reserve Bank has become an overbearing Lord, who will neither trust nor accept the opinion of the market and who has come to believe that It knows better despite sharing the same bits of economic information.

This is a rare monetary bird, not fixed, not pegged, not floating. It is a guided exchange rate that, when misbehaved, is threatened and cajoled. Consider the very typical comment made by the Chief Manager of the Reserve Bank's Financial Markets Department on Aug. 18, 1997: "Overall monetary conditions have become too loose, given our current monetary policy stance...We...have been waiting to see whether the drift in conditions in recent days would reverse. It hasn't, leaving overall conditions beyond levels that we are comfortable with. As usual, the Bank remains ready to act if necessary." The threat was to no avail, as the market continued to trade about 100 MCI points below the desired conditions. Just a few weeks later, the Reserve Bank sanctioned the lower market level! Threats and bluffs, not followed by any action — and then, capitulation.

This form of "dirty float" (the Reserve Bank, thankfully, does not intervene in the foreign exchange market — and has not intervened in over a decade) is unnerving and unwarranted. One can safely presume that the market knows better than the Bank the appropriate level of monetary conditions, because it is privy to the same type of information. This point should ring true to a Bank that has adopted an admirable banking supervision approach, which placed considerable emphasis on the role of the market in promoting a sound financial system.

Moreover it does not behoove a central bank to threaten and bluff; should it disagree with the market's assessments, it could easily resort to changing monetary conditions via a reduction or an increase in its cash settlement target. It is interesting to note that this cash settlement target *was not changed once throughout 1997* even as the market was "overreacting" on the downside (see Chart 5).

In a traditional and properly functioning floating rate regime, the central bank can vary high power or central bank money in an attempt to control money supply. The Reserve Bank can take its cue from the behavior of prices and act upon money supply when prices are moving away from target. It should not however engage in a futile game of forward-looking assessments, decide on specific MCI levels, and bluff/coax market participants to go along. If it persists, it will very soon lose all its hard-won credibility. And that too is bad news.

The good news is that *short of an overt easing move*, the market will do what it wants to do, regardless of Reserve Bank signaling. It pushed the exchange rate lower in anticipation of, or contemporaneously with, falling terms of trade (see Chart 6), developing problems in Asia, a widening current account deficit, a stronger US dollar, and very importantly, political uncertainty at home (the Winston Peters factor). Some, though not all, of these negative factors have begun to recede. Next month we will discuss them in more detail. Suffice it to say that the Reserve Bank's overreaction, signaling greater ease than the one indicated by the market, may merely reflect poor Bank intelligence — in very much the same way as the previous decline was resisted, with words only of course, by the Bank for more than nine months. Selling at the bottom?

STRATEGY: *The market is heavily short New Zealand dollars. This can be deduced by the extraordinarily high level of short-term interest rates, hovering around 9% when inflation is running below 2%. The Reserve Bank may not realize it, but interest rates will offset movement in the exchange rate thanks to the activity of the short sellers. When speculators sell short Kiwi, they borrow New Zealand dollars and tighten up rates, everything else being equal. When speculators cover short positions, they repay borrowers, and interest rates ease. Present levels have discounted most or all of the bad news. Though we hesitate to put out a buy signal yet, it is clear to us that it is too late to sell.*

Chart 6 — NZ Terms of Trade

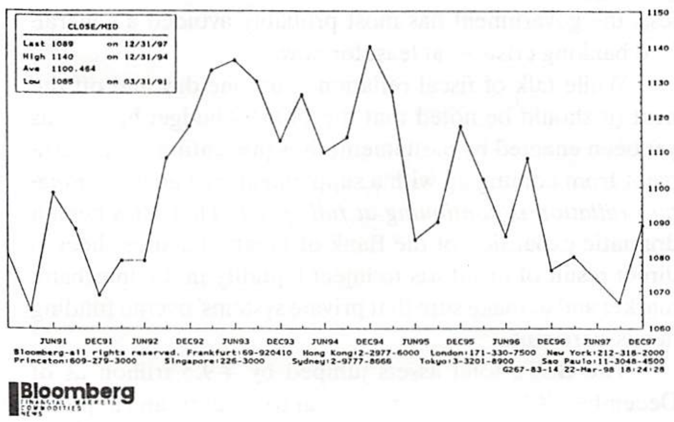
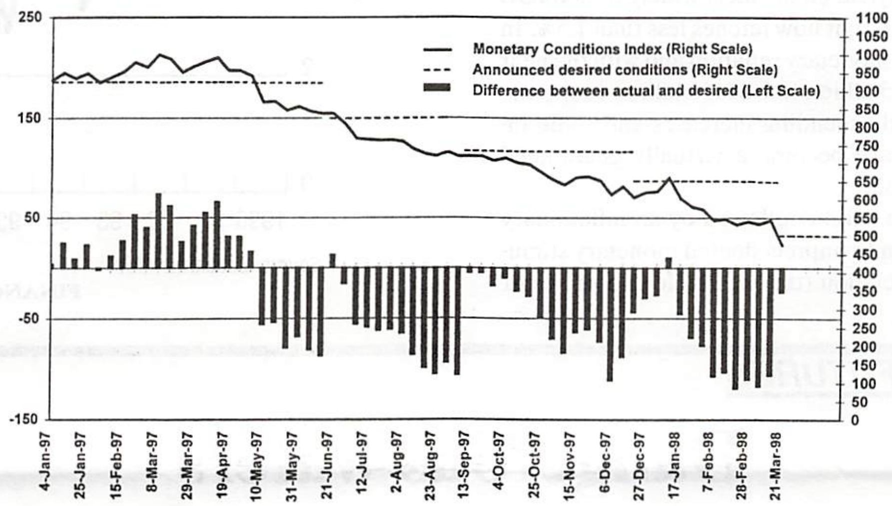


Chart 5

N.Z. Monetary Conditions Index and announced desired conditions



JAPAN

Japan's powerful reflation

Recent economic data confirmed the widely-held notion that Japan has entered a recession. For starters, fourth quarter Japanese real GDP declined 0.2% year on year; the first quarter is expected to show decline of 2.2% year on year, the weakest performance since 1974. Household spending has plunged to its lowest level in 11 years. Over the past three quarters, on average, corporate profits declined at a 17% annual rate. Business failures surged to a new high.

As a result of the sharp drop in economic activity, imports collapsed, producing a trade surplus 88% higher than the corresponding one a year ago. The 15% drop in imports in February against the same month last year was the biggest decline since May 1992. To make matters even more desperate, both the finance minister and the central bank governor resigned, taking responsibility for a number of corruption scandals that have tainted their subordinates.

With the passage of the financial stabilization bills committing ¥30 trillion of public funds to the deposit insurance scheme and to recapitalizing banks and with the actual infusion of ¥1.8 trillion into the largest money-center banks, by way of special debentures and preferred shares, the banking crisis has moved off stage. The entrenchment of banking overcapacity and the economic recession will surely claim a good number of bank failures in the months ahead. Nevertheless, the government has most probably avoided a generalized banking crisis — at least for now.

While talk of fiscal reflation is on one day and off the next (it should be noted that the 1998-99 budget has not as yet been enacted by parliament, thus preventing the government from coming up with a supplementary budget), *monetary reflation is continuing at full speed.* There has been a dramatic expansion of the Bank of Japan's balance sheet, a direct result of its efforts to inject liquidity in the interbank market and to make sure that private systems' overall funding needs were met.

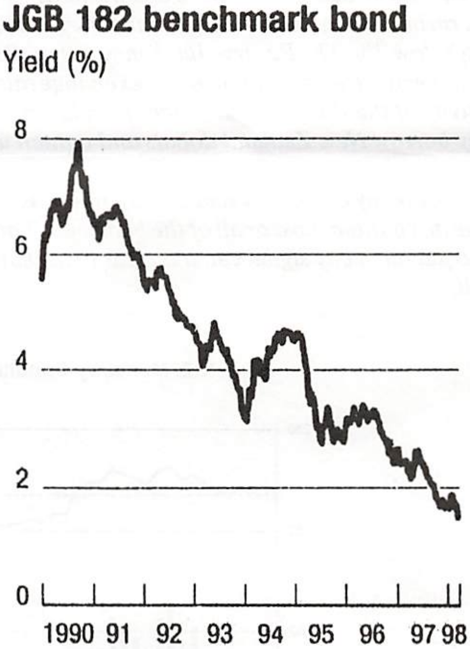
The BOJ's total assets jumped by ¥9.5 trillion as of December, ¥14.6 trillion in the year to January, and approximately ¥14.5 trillion in the year to mid March. At the end of January, the BOJ's total assets stood at ¥69.6 trillion, up 26.5% from a year earlier, while at mid-March, total assets had grown to ¥76.9 trillion. This extraordinary expansion of central bank money, in the absence of loan expansion, has forced yields in Japanese government bonds (JGBs) to the lowest levels in history for a comparable security (10-year maturity) anywhere in the globe.

Just 7 years ago the yield on the most widely traded JGB was about 8% (See Chart 7); it now fetches less than 1.5%. In the face of this dramatic monetary reflation and with the near certainty of a new US$75 billion to US$115 billion economic package that will include spending increases and some income tax cuts, JGBs have become a virtually guaranteed certificate of confiscation.

The economic turn will be followed by an inflationary surge, a delayed reaction to unprecedented monetary stimulus and currency depreciation (the profitable export sector points to a relatively undervalued yen). On a 3-year view, 10-year yields should easily attain 3%-4%.

STRATEGY: *Well-financed accounts should begin establishing short positions in JGBs. Yield declines should be used as an opportunity to add to positions. As to the yen, there are a number of countervailing forces at work that cloud future prospects. At this point we prefer to remain sidelined.*

Chart 7



Source: Datastream/ICV

FINANCIAL TIMES

STOCK INDEX FUTURES

Dangerous waters

Warnings of earnings disappointments in three leading technology companies had little more than a one-day dampening effect on the runaway bull. The same can be said for the slight firming in interest rates. We have in effect entered a stage of a financial bubble, where regardless of the kind of news, the market continues to rise.

According to statistics from the Fed, the Investment Company Institute, and the Employees Benefits Research Institute, US households actually sold a net $179 billion worth of stocks in 1997. In effect they bought a net $190 billion of stock through mutual funds and sold a net $369 billion of directly owned stock.

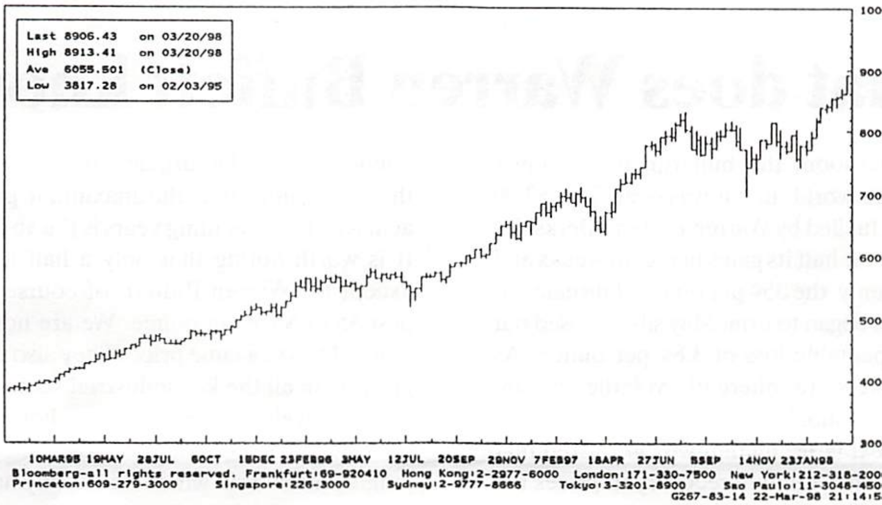
This surprising finding does not correlate well with the notion that the public is up to its ears in stocks — except that this simplistic flow of funds riddle does not take into account the extraordinary appreciation of stock prices since the end of 1990. Thanks to this appreciation, Americans had about $8.8 trillion invested in stocks directly and through stock mutual funds at the end of December, up from $2.5 trillion at the end of 1990. If not up to their ears, they are at least swimming in it.

Moreover, we surmise that there has been a qualitative deterioration: It is likely that the net selling was done primarily by company insiders (exercising options and/or liquidating outright holdings), while net buying was done by the much less informed mass of investors. The huge increase in public holdings in stocks and the likely redistribution of these holdings do not bode well.

Rising interest rates, when they come, will sound the death knell of the bull market. In the meantime only a fool will wade in these waters.

STRATEGY: *Remain sidelined.*

Chart 8 — Dow Jones Industrial Average



Bloomberg FINANCIAL MARKETS COMMODITIES NEWS

COPPER

Waiting to rejoin the bear

Last month we assured you that the bear is comfortable. As it happens, that assurance coincided with the lows from which rose a 15% rally. The move came with a backdrop of stories of mine closures and a perceived softening of the Asian crisis. In addition, warehouse stocks in London dropped 25,000 tonnes. Could the bottom be in?

We start our answer by putting the recent rally in perspective. Since this past summer, the price of copper has lost 50¢ a pound, a drop of 40%! A 15% rally of 11¢ is acceptable in the context of a bear market rally. For that matter, it is not uncommon for bear market rallies to extend as far as two thirds of the major downtrend.

The reasons for the rally are not completely unfounded. They are, however, merely grounds for a rally and not an end to the process that caused prices to crash in the first place. The Chinese have emerged as buyers, looking to scoop some bargains. As they push prices higher, analysts say, scrap finds its way back to the market, increasing supply to an already burdened market.

The key factor, which eventually ends all bear markets, is the price at which it is no longer profitable to produce the commodity. Soon enough, a seemingly endless glut will turn into tightness. Have we reached this price?

There have definitely been closings of some mines and output curbs at others. In the US alone some 250,000 tonnes of production will disappear because of mine closures by BHP Copper and Cyprus Amax. On the whole, though, global output is still rising. In fact we touched on this last month by illustrating how mines in state-controlled economies will continue to produce regardless of price. More significant, though, is the model of the Mexican industry, where costs are falling and production can grow, while profitability is maintained.

A larger example of this emerged this past week from mining giant Freeport-McMoRan. It announced that the expansion of its Grasberg mine in Indonesia will allow it to sell 771,115 tonnes of copper in 1998, up 44% from last year. What is most startling, though, is that production costs could fall to as low as 40¢ per pound, down from 51¢ in 1997, according to Freeport. It claims, further, that the by-product gold production from the Grasberg mine could lower cost of copper production to as low as 20¢ per pound, with a price of gold at $300 per ounce! With prices at 80¢ a pound, it will be some time before mining companies such as these start sweating.

The rally may have run its course. Short-covering has spent some of the burdensome open interest. Even more interesting is the contango in London. The cash-to-three-month spread had risen to $18 dollars a tonne during the rally, after bottoming at about $30 when prices were at their lows. With prices just a bit off the highs of an 11¢ per pound rally, the contango is back at $27 a tonne. This indicates that any rally does in fact bring scrap into the market and makes quick work of any budding tightness.

The evidence is in and it would seem that we have not yet reached the price at which production cutbacks would start creating supply/demand deficits. We watch carefully for the right moment to rejoin the bear.

STRATEGY: *Stand by for new sell recommendation.*

— **Sholom Sanik**

SILVER

What does Warren Buffett know?

This past Thursday afternoon, the bull run in the silver market looked, for all the world, like it was over. The $3.50 per ounce climb that was fuelled by Warren Buffett's Berkshire Hathaway had given up over half its gains in recent weeks and was falling rapidly. Suddenly, the 35¢ per ounce slide came to an abrupt halt, and prices began to firm. May silver closed out the day with a very respectable loss of 3.8¢ per ounce. As commodity futures markets are inherently volatile and unpredictable, we were not in shock.

It wasn't until the next morning that we discovered that there was a story behind the stunning recovery in prices the previous session. It seems that there might be a very concrete, commercial reason behind Mr. Buffett sudden interest in silver bullion. In Berkshire Hathaway's original communiqué explaining the huge silver purchase, there was talk of an equilibrium between supply and demand being reached only at higher prices. The explanation of the fundamentals, however, was not nearly as bold as the statement made by the purchase of 129 million ounces of silver. A report by an industry consulting firm started to make some sense of the outlandish shopping spree. They deduced that since Berkshire Hathaway is a major shareholder in Gillette, which is the parent company of Duracell, there must be some battery connection.

Until now, high energy, rechargeable silver-zinc batteries were used in space and defense applications. However, scientists are moving quickly to make this technology commercially viable for cars, laptops, and cellular phones. Has Mr. Buffett been stocking up for Duracell? Mr. Buffett has neither admitted nor denied this link.

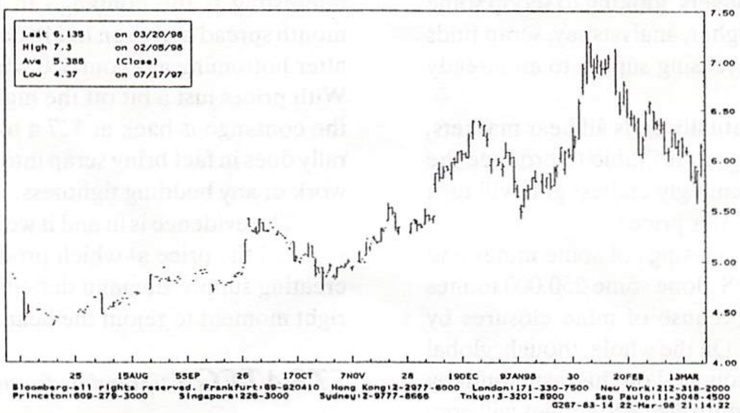
A report by The Silver Institute last week had some real statistics to report on the silver market, rather than a mere futuristic outlook. They stated that "...rising silver mine production will not be sufficient to meet demand." Nonetheless, they conclude, that the maximum price level that can be achieved in the coming years is the $6 to $7- per-ounce range. It is worth noting that only a half a year ago, nobody — except for Warren Buffett, of course — dared even dream past $5 or $5.50 an ounce. We are now considering a maximum of $7.00, a lame price. They also confirm that demand is growing in all the key industrial sectors of the silver market, such as jewelry, silverware, and photography.

Two indicators that we consider to be reliable tools for judging markets in which we already have a bias are telling us that the market is perhaps becoming a buy again. Sentiment readings show that commodity trading advisors are split about 50-50 between bulls and bears. Typically, the weak hands stay long past their welcome, and joining them is a recipe only for sharing the pain they almost always end up with. Current readings, considering the kind of mom-and-pop speculators a run in silver usually brings out, is quite moderate. Then there is the open interest, which ran up to 113,000 contracts but has shed 26,000 contracts in the decline from the highs. This confirms, indeed that weak-handed speculators have left this market, for now, and is very much in line with what the sentiment readings are telling us. The original rally, before the Warren Buffett story broke on Feb. 3, was characterized by low open interest. When the market first peaked at the end of December, just shy of $6.50 an ounce, open interest was a very manageable 99,000 contracts. It is just such a pattern — strength with a well-contained open interest — that would get us back into this market.

STRATEGY: *Wait to buy until clearer signs emerge that the correction has ended.*

— Sholom Sanik

Chart 9 — Silver Futures



Bloomberg

SOY COMPLEX

No shortage of bull

The price of soybean meal has come full circle. From the spring of 1995 until the peak in the spring of 1997, the price of meal more than doubled. Prices started to decline when the promise of larger crops surfaced. The slide accelerated in earnest when the Asian crisis hit. After 2 years of a pretty exciting bull market, the market now finds itself back to the boring level of $175 a tonne, which is where meal prices spent the first half of this decade, give or take a few bucks. Soybeans have been falling but are still not cheap at $6.50 per bushel.

While the meal set the tone for the direction of beans thus far, the job is now being taken over by soybean oil. With the breakout above 26¢ per pound, prices have broken a downtrend that dates back to early 1994. Besides the more permanent issue of growing global consumption of vegetable oils, the Indonesian ban on exports of palm oil has fuelled this rally. Originally, the ban was to end on April 1, but this past week the Indonesian government announced that the export ban will be extended until further notice.

One thing is for certain, there is no shortage of bullish angles on soyoil prices. In the March 12 USDA supply/demand situation report, the estimate for exports was raised yet again by 100 million pounds to 1.17 million tonnes, or 27% above last year's exports. The export commitments this past week were rather lame at 12,400 tonnes and below analysts' expectations. The average for the last four weeks, though, was 33,650 tonnes, which if annualized still exceeds the USDA estimate by a wide margin. Since the numbers were released, the Chinese bought 20,000 tonnes towards the next reporting period. That is the demand side.

On the supply side, The National Oilseed Processors Association's (NOPA) February crush report carried some unexpected bullish highlights. February is typically a quiet month for crushing. Nonetheless, a record number of soybeans were crushed, 135 million bushels, compared with 123 million bushels last February. Despite this, the NOPA data showed that soyoil stocks fell to 1.426 billion pounds vs. 1.894 last February. Partially accounting for this was a drop in yield of 0.11 lbs. per processed bushel.

The trend of a higher rate of growth in consumption than that of production was confirmed by the voice of the edible oil market, *Oil World*. On March 10 it forecasted that this year would see tightness in the world's four major edible oils: soy, palm, sunflower, and rapeseed. Although 1997-98 production would rise 3.3% to 60.9 million tonnes, consumption will grow by 4.7% to 62.1 million tonnes. Interestingly, it says it has already made allowances for the loss of demand from the Asian crisis. That is the bullish picture.

We are now in between the North American and South American crops. Barring unforeseen weather calamities, Brazil and Argentina will produce about 8 million tonnes of soybeans more than last year. As they will soon start coming on stream with their crops, they could alleviate any tightness there is in the oil market. As we pointed to last month, Indonesia will not keep the export ban on indefinitely because oil does not last forever. Allowing it to spoil and become unmarketable would serve no purpose.

Finally, although the rising price of soyoil is clearly representative of the fundamentals, the rise in open interest indicates that many speculators, large and small, are subscribing to this story. Since the rally began in the fall, open interest has grown by some 60,000 contracts, or 65%. If something were to trigger a selloff, a lift of the Indonesian export ban for example, important enough to make the large commodity funds start selling, it would be a painful experience to be long. On the other hand, there is a point at which the trade would no longer be able to bear the heat and the massive short-covering rally that would ensue would be equally disastrous for shorts.

We maintain last month's view. A lift of the export ban that causes a healthy selloff with shedding open interest will offer an entry point to this potentially explosive bull market.

STRATEGY: *Stand aside.*

— Sholom Sanik

COCOA

Confused, but still nimble

The story in cocoa has been swinging wildly, and it is reflected in equally wild swings in the price. In the past year we've moved from breakdowns to breakouts and back again, only to end up where we are now, in the middle of the range.

Last year the market struggled to choose between the implications of a 40% stocks-to-consumption ratio or a potential crop failure resulting from irregular weather patterns courtesy of El Niño. A few months ago, as Ivory Coast arrivals started overtaking year-ago levels, it seemed clear that yet another record crop was in the bag. El Niño may very well have spoiled your brother-in-law's vacation, but it had little effect on cocoa plantations in West Africa. So said virtually every analyst, aside from Commodity Minister Gauze, of course. The market made new lows going back to last spring, and all were talking breakdown, again. We've snapped back once more, and this new pattern requires a fresh explanation, although we do not guarantee that we can provide it.

Following the news that comes out of that part of the world is an exhausting exercise, because it keeps changing, and you'll never really know which to believe. A few weeks ago the stories we read on the various news wires that we subscribe to were so bearish, be it the weather angle or the sluggish European demand angle, that you couldn't wait for the opening tick to pound the short side of the market. The downside didn't last very long, as prices turned upwards and the wags had to find an explanation. Then, on March 19, a story ran on one of the wires entitled "Traders fear Ivorian cocoa supply 'nightmare.'" Nightmare? what happened to the 40% stocks-to-consumption carryout. Even according to the ICCO, the years of deficits will bring the ratio down to 34%, and only after their orchestrated production cutbacks take effect.

Actually, the evidence in the market is bullish. The contango in this market, outside of a few short-lived exceptions, has been so ample that it dwarfed the cost of carry of just about any other commodity market. So, when this changes, it pays to take note. In this past runup in prices, the spread between May and September has narrowed from $64 a tonne back at the end of January to $26 a tonne this past Friday. The spot month has not been so tight in nearly a year, even with the market at higher prices.

One theory that has emerged is that the huge carryover stockpile that gives us a 40% stocks-to-consumption ratio is made up largely of older and smaller beans that do not meet the standards of European chocolate manufacturers. While we have no hard evidence one way or the other, we can say that this theory is not responsible for the recent rally. First the contango at the Coffee Sugar & Cocoa Exchange in New York, whose delivery requirements are less stringent than those of the London Commodity Exchange, has narrowed considerably more than its counterpart in London. Then a spread between London and New York in nominal terms, if anything, shows New York to be stronger.

We stand stopped out of our short position, admittedly a bit confused, but nimble as ever, waiting for the next opportunity in this, the choppiest of markets.

STRATEGY: *Stand aside.*

— Sholom Sanik

Chart 10 — Friedberg Capital Markets
Recommended current portfolio allocations

1. Various Short-Term US$ Notes	5%	5. US Treasury 6.25% '02 (US$)	7.5%
2. Argentina T-Bill (LETES) (US$)	10%	6. Trans Tasman 9% '99 (NZ$)	5%
3. KIPT 9% cv (NZ$)	15%	7. 10-year BUNDs, hedged (US$)	7.5%
4. Kgdm. of Sweden FRN '01 (US$)	50%		

Chart 11 — FOREIGN CURRENCY BONDS

DATE: March 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		104.05	104.90	3.91		Oct-13
World Bank 9% 13/11/00 RRSP eligible		111.00	-	-		Nov-13
Argentina 8% 5/10/98		100.50	-	-		Oct-05
Kgdm. of Spain (6 Mo. LIBOR-1/16) 29/6/02 (semi)		99.98	100.28	-	3.75	Jun-29
CZECH REPUBLIC KORUNA BONDS						
General Electric Cap. Corp. 10.5% 23/10/98		95.95	-	-		Oct-23
Nordic Inves. Bk 10.625% 10/11/00		90.20	-	-		Nov-10
SWISS FRANC DENOMINATED BONDS						
General Electric Cap. Corp. 4 3/4% 2/7/98		100.65	-	-		Jul-02
General Electric Cap. Corp. 4 1/2% 17/12/99		103.80	-	-		Dec-17
DANISH KRONE DENOMINATED BONDS						
Kgdm. of Denmark 9% 15/11/98		102.35	103.20	3.78		Nov-15
ECU DENOMINATED BONDS						
United Kingdom 9 1/8% 21/02/01		112.35	113.20	4.20		Feb-21
BRITISH POUND DENOMINATED BONDS						
European Invt. Bk. 7% 22/12/98		98.90	99.75	7.22		Dec-22
Kgdm. of Denmark FRN 28/8/98 3mo LIBOR-12.5b.p.(qtly)		99.73	-	-	7.4375	May-27
CANADIAN DOLLAR DENOMINATED BONDS						
Ontario Province 10 5/8% 15/7/98 RRSP eligible		100.90	102.15	3.28		Jul-15
Petromet Resources 6.5% 31/3/04 (semi) CV @ $9.50 p/sh		93.25	-	-		Mar-31
SOUTH AFRICAN RAND DENOMINATED BONDS						
ESCOM 11% 1/6/08 (semi)		86.20	87.70	13.23		Jun-01
AUSTRALIAN DOLLAR DENOMINATED BONDS						
Toronto Dominion Bk. Aust. 7.25% 26/2/99 RRSP eligible		102.05	102.90	3.96		Feb-26
NEW ZEALAND DOLLAR DENOMINATED BONDS						
World Bank 8.25% 30/4/99 RRSP eligible		98.70	99.55	8.67		Apr-30
New Zealand Gov't 8% 15/7/98 (semi)		99.10	99.95	8.11		Jul-15
Ontario Province 7.15% 24/11/98 (semi)		98.15	99.00	8.71		May-24
Fletcher Challenge 10.15% 30/11/98 CV (semi)		99.20	100.05	10.03		May-31
Tranz Rail Ltd. 10% 15/10/99 (semi)		100.25	-	-		Apr-15
Trans Tasman 9% 27/6/99 CV (semi)	*	87.25	88.10	20.10		Jun-26
St. Luke 8.7% 1/4/99 (semi) CV @ 1.00 p/sh	*	151.45	153.45	17.10		Apr-01
Kiwi Income Prop. Trust 9% 30/9/03 CV (semi)	*	115.25	117.25	9.60		Mar-31
ARGENTINEAN PESO DENOMINATED BONDS	PAR VALUE			IRR		
Bocon Pre 1: 1/4/2001	106.8068	97.00	98.75	8.82		Apr-01-98
U.S. DOLLAR DENOMINATED FIXED CONV. BONDS						
Coeur D'Alene 6% 10/6/02 CV@ 26.00 p/sh		78.25	79.75	12.45		Jun-10
JumboSports 4 1/4% (semi) 11/1/00 CV @ 25.5 p/sh		39.25	-	-		May-01
The Learning Co. 5 1/2% (semi) 11/1/00 CV @ $53.00 p/sh		90.25	91.75	9.13		May-01
Novacare Inc. 5.5% (semi) 15/1/00 CV @ $26.65 p/sh		94.75	96.25	7.76		Jul-15
U.S. DOLLAR DENOMINATED FIXED RATE BONDS						
Argentina T-Bill (LETES) 0% 16/10/98		96.21	96.33	6.69		Oct-16
U.S. Treasury 6.25% (semi) 28/2/02		102.00	102.30	5.59		Aug-31
U.S. Treasury 6.375% (semi) 15/8/27		105.75	106.35	5.92		Aug-15
U.S. Treasury Coupon Strips 0% 15/2/25		19.95	20.25	6.03		Feb-15-25
U.S. Treasury Principal Strips 0% 15/2/25		19.95	20.25	6.03		Feb-15-25
World Bank 7 1/8% 27/9/99 (semi) RRSP eligible		101.85	102.70	5.24		Mar-27
Conn. Lt. & Pwr. 5.5% (semi) 1/2/99		98.98	99.13	6.56		Aug-01
Mobile Telecomm 13.5% (semi) 15/12/02		117.75	118.60	8.61		Jun-15
U.S. DOLLAR DENOMINATED FLOATING RATE NOTES						
Canada Gov't 10/2/99 3 mo. LIBOR - 1/4 (qtly), callable @ 100 RRSP eligible		99.80	100.10	-	5.3750	May-13
Kgdm. of Sweden FRN 15/2/01 3mo LIBOR-12.5b.p.(qtly)		99.97	100.27	-	5.50391	May-12
Bocon 1/4/01 (30 day LIBOR) starts paying May 1,'97	PAR: 102.4301	98.50	-	-		Apr-01-98
Argentina: Series L:FRB 31/3/05, 6 mo. LIBOR+13/16 (semi)	PAR: 96	91.75	93.25	8.64	6.6875	Mar-31
Venezuela: DCB: 18/12/07, 6 mo. LIBOR+7/8 (semi)	PAR: 95.2381	90.10	-	-	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

HOTLINE UPDATE

Tuesday, February 24, 1998:
Good afternoon for Tuesday, February 24. There are no changes or new recommendations.

***Flash Update:* Friday, February 27, 1998:**
Good morning for Friday, February 27, 9:30 am. This is a flash update. Cover short March Japanese yen at the market, presently trading at 7960.

***Flash Update:* Tuesday, March 3, 1998:**
Good morning for Tuesday, March 3, 9:30 am. This is a flash update. Liquidate long May silver positions at the market, presently trading at 640.00, cancelling the previous stop of 540, good anytime.

Tuesday, March 3, 1998:
Good afternoon for Tuesday, March 3. We have one new recommendation: Adjust the stop on short copper to .8225, basis May, good anytime, from .8200, basis March.

Friday, March 6, 1998:
Good afternoon for Friday, March 6. There are no changes or new recommendations. The following is a recap of this week's recommendations.

- On Tuesday, March 3, via flash update, we advised liquidating long May silver positions at the market, then trading at 640.00, cancelling the previous stop of 540.00 good anytime AND adjusting the stop of short copper to .8225 basis May, good anytime, from .8200, basis March.

Friday, March 13, 1998:
Good afternoon for Friday March 13. We have one new recommendation: Buy July silver at the market.

***Flash Update:* Tuesday, March 17, 1998:**
Good morning for Tuesday March 17, 8:40 am. This is a flash update. Buy June gold at the market, presently trading at 296.00.

Tuesday, March 17, 1998:
Good afternoon for Tuesday, March 17. We have no new recommendations. We repeat the flash update of earlier today in which we recommended to buy June gold at the market, then trading at 296.00.

***Flash Update:* Thursday, March 19, 1998:**
Good morning for Thursday, March 19, 10:05 am. This is a flash update. Liquidate long July silver at the market, presently trading at 570.00.

Friday, March 20, 1998:
Good afternoon for Friday, March 20. This is a complete summary, since our last market letter dated February 21, of all liquidations of open positions and new recommendations that remain outstanding.

- On Friday, February 27, via Flash Update, we advised covering short March Japanese yen at the market, then trading at .7960.
- On Tuesday, March 3, via Flash Update, we advised liquidating long May silver at the market, then trading at 640.00 AND adjusting the stop on short copper to .8225, basis May, from .8200 basis March. This position was subsequently stopped out on March 5.
- On Tuesday, March 17, via Flash Update, we advised buying June gold at the market, then trading at 296.00.

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