FRIEDBERG'S

COMMODITY & CURRENCY COMMENTS

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America's bubble economy

So led the main editorial in *The Economist's* April 18 issue. The sobering article, reinforced by a second one, expressively entitled "America bubbles over," makes the same point that our readers have become accustomed to reading in these pages: America is experiencing a serious asset-price bubble. *The Economist's* article concludes that "The Fed needs to raise interest rates now... In the late 1920s the Fed was also reluctant to raise interest rates in response to surging share prices, leaving rampant bank lending to push prices higher still. When the Fed did belatedly act, the bubble burst with a vengeance." *The Economist* warns that "the longer the asset prices continue to be pumped up by easy money, the more inflated the bubble will become, and the more painful the economic after effects when it bursts."

Ten months ago, in a piece entitled "70 years later, the same dilemma" (see our June 1997 issue), we drew exactly the same conclusions from exactly the same parallels. We ended by noting that "Seventy years on, the Fed faces a frighteningly similar dilemma: to put an end to the boom in the securities markets by sharply raising interest rates, and risk a serious economic contraction, or to follow Milton Friedman's advice (would he proffer the same advice today?) [He did, in an article, reprinted in our August 1997 issue -- ed.] to stay the course with regard to monetary policy and allow speculation to burn itself out, hoping for a miraculous economic soft landing in the face of an horrendous eventual crash?...Those who cannot remember the past, it has been said, are condemned to repeat it."

Ten crucial months have passed. Since then, a few trillion dollars have been added to overall market capitalization, and millions of poorly informed new investors have joined the fray. Speculative fires have not burned themselves out; if anything, they have been stoked by formidable intellectual arguments (see next article). They now threaten to engulf the US economy in an infernal destruction. It may just be too late.

Cooler voices than ours are now sounding the alarm.

In this issue

Contributions by Albert D. Friedberg, Steve H. Hanke, James K. Glassman and Kevin A. Hassett, Sholom Sanik.

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

S&P 500

Rationalizing mania

We have reprinted nearby a highly provocative article by two prominent scholars, recently published in *The Wall Street Journal*. James Glassman and Kevin Hassett attempt to provide an intellectual basis for the current stock mania sweeping the land. Unlike investment firms' opinions and recommendations, their argument is firmly founded on modern finance theory. Its simple elegance is breathtaking and – persuasive – but has little predictive value.

The essence of the argument runs as follows: Over the past 70 years, stocks have returned 4.8 percentage points per annum more than long-term US Treasury bonds. That extra reward, or "equity premium," is merely the extra compensation paid by the market to investors who accept high risks. But, they argue, if stocks in the long run always outperform bonds, why the extra risk? They conclude that the risk premium should disappear. For that to happen, the stock market would need to rise anywhere between 100% and 340% (unless, of course, interest rates rose sharply from these levels).

Two weeks after their article appeared, Dr. Jeremy J. Siegel, on whose work the authors based their argument, disputed their contention in a letter to the editor of *The Wall Street Journal*. He pointed out a flaw in their argument. "It is totally unrealistic and contrary to historical data," he wrote, "to assume that per share cash flows will grow [at the rate of growth of the economy] without "borrowing" from either current or prospective investors." He concluded that it was "wrong to say that stocks are underpriced at current levels."

Glassman and Hassett are probably correct in identifying the reason why multiples have expanded so dramatically: the notion that has gained currency, because of studies such as the ones produced by Dr. Siegel, that common stocks are the best long-run investment. The problem is that the long run (in their argument, 20 years) is too long a run. In good times people are optimistic and are willing to commit funds for long periods of time. Because they are optimistic, they cannot envision losses. Though they can utter the word "risk", they cannot fathom its consequence. Thus, they are willing to bid up prices to such an extent as to eliminate the equity premium. That is a rational response in view of the historical data.

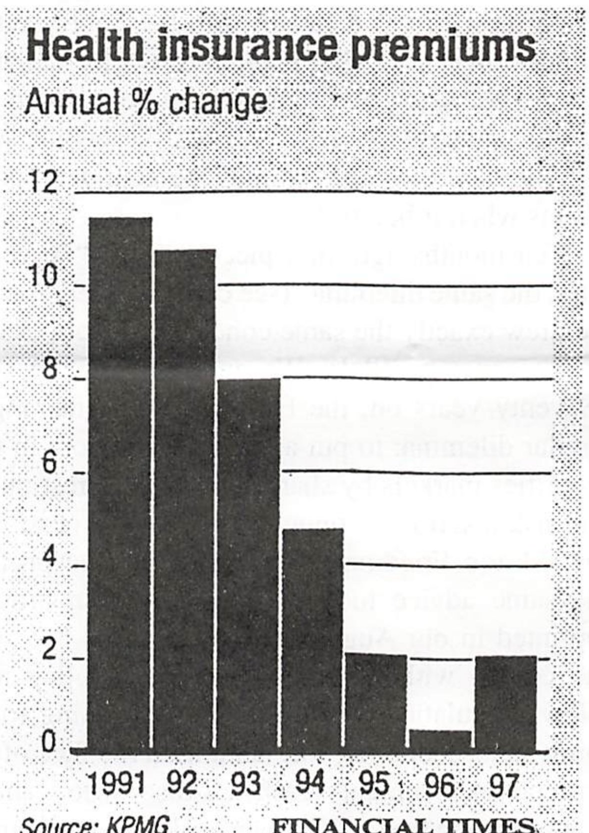
Human beings, however, will accept only rational arguments that fit their moods. In bad times, no amount of data will persuade them to take the long view. Instead investors will concentrate on three-year or five-year rolling returns that demonstrate that, indeed, stocks are far riskier than alternative investments and that therefore a risk premium is fully justified.

Glassman and Hassett have successfully rationalized the current mania. And why not? Human beings are rational: Somehow they need to justify present valuations. Their argument may be valid for all times, but it will fall on receptive ears only during the good times. It therefore cannot provide a reliable forecast: If optimism continues to reign, stock prices may continue to rise, which is no more than a simple truism.

The thesis advanced by Glassman and Hassett will do no more than give us an upper limit to valuations: 100 times earnings, *under present conditions*. Far more useful would be to know for how long will optimism reign. How and when will conditions change? What will make them change?

In fact, the elements of change *already* exist: Corporate earnings are crumbling; service inflation is on the rise (for an example, see Chart 1), while goods deflation has been arrested; interest rates must rise (either because of asset inflation or because of plain inflation); emerging nations are going deeper into debt. Which factor or combination of factors will trigger a change of sentiment? While we don't know the answer, we are certain that the time is not too far off. In which case one would have to say, *pace* Glassman and Hassett, that stocks are indeed overvalued.

Chart 1



STOCK MARKETS

Are stocks overvalued? Not a chance.

By James K. Glassman and Kevin A. Hassett

The Dow Jones Industrial Average has returned more than 200% over the past five years, and the past three have set an all-time record. So it's hardly surprising that many observers worry the stock market is overvalued. One of the most popular measures of valuation, the ratio of a stock's price to its earnings per share – P/E – is close to an all-time high. The P/E of the average stock on the Dow is 22.5, meaning that it costs $22.50 to buy $1 in profits – or, conversely, that an investor's return (earnings divided by price) is just 4.4%, vs. 5.9% for long-term Treasury bonds.

Yet Warren Buffett, chairman of Berkshire Hathaway Corp. and the most successful large-scale investor of our time, told shareholders in a March 14 letter that "there is no reason to think of stocks as generally overvalued" as long as interest rates remain low and businesses continue to operate as profitably as they have in recent years. Investors were buoyed by this statement, even though Mr. Buffett provided no analysis to back up his assertion.

Widespread misunderstanding

Mr. Buffett is right – and we have the numbers and the theory to back him up. Worries about overvaluation, we believe, are based on a serious and widespread misunderstanding of the returns and risks associated with equities. We are not so foolish as to predict the short-term course of stocks, but we are not reluctant to state that, based on modest assumptions about interest rates and profit levels, current P/E levels give us no great concern – nor would levels as much as twice as high.

The fact is that if you hold stocks instead of bonds, the amount of money flowing into your pockets will be higher over time. Why? Both bonds and stocks provide their owners with a flow of cash over time. For bonds, the arithmetic is simple: If you buy a $10,000 bond paying 6% interest today, you'll receive $600 every year. For equities, the math is more complicated: Assume that a stock currently yields 2%, or $2 for each share priced at $100. Say you own 100 shares; total dividend payments are $200 – much lower than for bonds.

But wait. There is a big difference. Profits grow over time. If that dividend should increase with profits, say at a rate of 5% annually, then, by the 30th year, your annual dividend payment will be over $800, or one-third more than the bond is yielding. The price of the stock almost certainly will have risen as well.

By this simple exercise, we can see that stocks – even with their profits growing at a moderate 5% – will return far more than bonds over long periods. Over the past 70 years, stocks have annually returned 4.8 percentage points more than long-term U.S. Treasury bonds and 6.8 points more than Treasury bills, according to Ibbotston Associates Inc., a Chicago research firm.

But isn't that extra reward – what economists call the "equity premium" – merely the bonus paid by the market to investors who accept higher risk, since returns for stocks are so much more uncertain than for bonds? To this question, we respond: What extra risk?

In his book "Stocks for the Long Run," Jeremy J. Siegel of the University of Pennsylvania concludes: "It is widely known the stock returns, on average, exceed bonds in the long run. But it is little known that in the long run, the risks in stocks are less than those found in bonds or even bills!" Mr. Siegel looked at every 20-year holding period from 1802 to 1992 and found that the worst real return for stocks was an annual average of 1.2% and the best was an annual average of 12.6%. For long-term bonds, the range was *minus* 3.1% to plus 8.8%; for T-bills, minus 3.0% to plus 8.3%.

Based on these findings, it would seem that there should be no need for an equity risk premium at all – and that the correct valuation for the stock market would be one that equalizes the present value of cash flow between stocks and bonds in the long run. Think of the market as offering you two assets, one that will pay you $1,000 over the next 30 years in a steady stream and another that, just as surely, will pay you the $1,000, but the cash flow will vary from year to year. Assuming you're investing for the long term, you will value them about the same.

What valuation level of the stock market would equalize the income flow from stocks and bonds? To keep the calculations simple, we will pretend that you can buy a perpetuity (an annuity that lasts forever) that pays 5.9% – about the current long-term T-bond rate. Assume that the flow of payments you receive when you buy a stock is also a perpetuity. Also assume that after-tax earnings are a reasonable estimate of the cash flow from a stock, that future inflation will be 2.8% annually, and that real earnings will grow at the same rate as the rest of the economy, 2.1% a year. (Currently inflation is far lower and growth far higher, but we're using the long-run assumptions of the Congressional Budget Office.)

Using a simple and accepted formula, we find that the P/E that would equalize the present value of the cash flow from stocks and bonds is about 100. By this measure, the stock market is undervalued by a factor of about four. At current prices, the flow of cash associated with holding stocks for many years is four times as high as that for bonds.

Does that mean the Dow ought to be 35000 instead of 8800? Not quite. There are three important qualifications. First, the present-value calculations will change a great deal if the real growth-rate assumptions change only a little. If growth falls even a little short, the cash flow from stocks and bonds looks more similar.

Second, we assumed that there was no risk premium at all in the long run, as Mr. Siegel's research shows. But that may overstate the case. For the premium to vanish, investors must hold their shares in a diversified portfolio for at least 20 years. In practice, investors often waver. A sensible question, therefore, would be: How would our calculations change if we introduced a risk premium, which would increase the rate at which you discount expected future cash flows? As it turns out, a fairly modest risk premium of about 3% would imply that the market is currently valued correctly. Again, however, that premium is higher than history indicates it should be.

Finally, earnings might not be the best measure of the cash flow associated with holding a stock. Suppose, for example, firms are retaining lots of money today because they anticipate having to make big capital expenditures in the future in order to maintain growth. It may be that dividends are a better measure, and dividends are much lower than earnings. Dividends are probably an underestimate of the cash flow, since many big profitable companies, such as Microsoft, pay none at all. But making the same growth and inflation assumptions as before, a payout of merely 1% would equalize the present value of cash flow from holding stocks with that currently received by bondholders. The Dow now yields 1.5%. Adding an estimate about the current level of share repurchases (the equivalent of dividends) the total cash flow from firms to current shareholders is probably about 2%. That means that even by the dividend measure, the market is undervalued by about 50%.

Taking the long view

Allow us now to suggest a hypothesis about the huge returns posted by the stock market over the past few years: As mutual funds have advertised the reduction of risk acquired by taking the long view, the risk premium required by shareholders has gradually drifted down. Since Siegel's results suggest that the correct risk premium might be zero, this drift downward – and the corresponding trend toward higher stock prices – may not be over.

In order for the risk premium to go all the way to zero, the market would need to rise by between 100% (the dividend measure) and 340% (the earnings measure). We wouldn't bet the ranch on such an enormous and immediate increase. After all, subtle variations in parameters we cannot possibly predict, such as the growth rate or inflation rate, lead to big changes in conclusions. The cash flow between bonds and stocks would also be equalized, for example, if the stock market stayed where it is, and the interest rate on long bonds climbed to about 9.5%. However, in the current environment, we are very comfortable both in holding stocks and in saying that pundits who claim the market is overvalued are foolish.

Mr. Glassman is a resident fellow and Mr. Hassett a resident scholar at the American Enterprise Institute.

US INTEREST RATES

Putting our money where our mouth is

Rapid rates of growth in the monetary aggregates continue to warn of significantly higher inflation ahead. For the latest two months, M2 has accelerated to an 8.9% annual rate of growth, well above the top of its monitoring range of 1%-5%. At the same time, M1 has clearly moved into positive territory and is now growing at a 2.7% annualized rate. This rate of growth, if it persists, will almost certainly translate into an *accelerating* rate of inflation, given rising M1 velocity – see our March issue: "Inflation risks: The Fed (and most everyone else) is in denial."

What would derail this forecast? A sharp widening in the current account deficit, itself a sign of building inflationary pressures, and/or an above-average increase in productivity. A current account deficit lets the steam off the boiling pot and thus acts to reduce inflationary pressures on domestic prices. But this is only a temporary stopgap. A widening current account deficit that has its origins in monetary disorders emits a powerful signal for foreign exchange participants: that it won't be long before the currency comes under pressure. Soon thereafter domestic inflation accelerates.

As for productivity, it is unlikely to improve at this stage of the cycle. This is confirmed by the worsening outlook for corporate profits. Thus we are left with the near-certainty that price inflation will begin to accelerate in the next few months, as soon as the deflationary effect of falling commodity prices works itself out (see Chart 2 and 2A).

An interesting way to bet on this occurrence while earning a respectable rate of return is via the purchase of Treasury Inflation Protection Securities (TIPS). The Treasury began issuing TIPS in January 1997. There are presently four issues outstanding, with various maturities ranging from 2002 to 2028 (see Chart 3).

The value of the principal is adjusted for inflation each day, using changes in the CPI as a benchmark. The CPI measure used is not seasonally adjusted and is for all urban consumers (CPI-U). To calculate the principal adjustment, the index is lagged three months because of the time it takes to publish it and because of the Treasury's desire to interpolate a day-by-day linear trend in every month.

For example, the CPI applicable to April 1 is the reading for January, which is released to the public in February. For the remaining days in April, the CPI is calculated by linear interpolation between the reading applicable to the first day of the month (January's CPI) and the reading applicable to the first day of the following month (February's CPI). Every six months, a fixed-rated coupon is issued, with its payment based on the revised principal amount.

A TIPS principal grows at the same rate as inflation; thus, it maintains its real value in terms of the market basket of goods that makes up the CPI. The fixed-rate coupon also rises in proportion to the increase in the principal.

On April 15 the Treasury issued a new 30-year TIPS, with a coupon of 3 5/8% and at a price of just under 98, for a real yield to maturity of 3.74%. (Of course the calculation of the real yield to maturity depends on the assumed rate of inflation for the life of the instrument).

The simplest way to view the securities is on a break-even basis with the corresponding same maturity, standard (nominal) Treasury bond. On April 17 the 30-year (generic) nominal Treasury bond traded to yield 5.88% to maturity, while the TIPS traded to yield 3.70% to maturity. The difference represented the market's assessment of what inflation was likely to be for the next 30 years. Should inflation turn out higher than 2.18%, the TIPS would provide a better return.

For reference, March 1998/March 1997 inflation was 1.37%, while the March 1998 annualized rate was 2.25%. We should note that from the '60s to the present, the real rate of return on nominal bonds ranged from –1.6 to 9.5%, averaging only 1.67%. Furthermore, nominal Treasury bonds yielded negative real returns for virtually the entire high inflation decade of 1974 to 1984.

In our opinion the TIPS offer an extremely interesting investment opportunity. This is because we believe that inflation will exceed 2.18%, the present breakeven differential. We observe that in periods of high inflation and consequently high nominal interest rates, real yields decline, (while the converse is true, of course, during periods of low inflation and low nominal interest rates). We theorize that this has something to do with a sort of money illusion. Consequently, holders of TIPS will not only avoid the natural price decline exhibited by nominal securities during periods of rising interest rates, but they are likely to enjoy substantial capital appreciation, as real yields decline and TIPS prices increase. (In the UK, index-linked gilts have moved from real yields of 3.7% to less than 3% over the past 10 months as inflationary pressures and expectations mounted).

STRATEGY: *We recommend that global bond portfolios should begin establishing moderate- to fair-size positions in Treasury Inflation Protection Securities.*

Chart 2 – Journal of Commerce Industrial Price Index

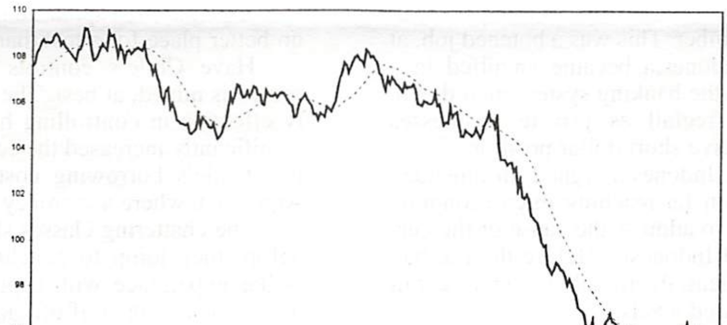


Chart 2A – Journal of Commerce Industrial Price Index Y/Y % change of 1-month Moving Aerage

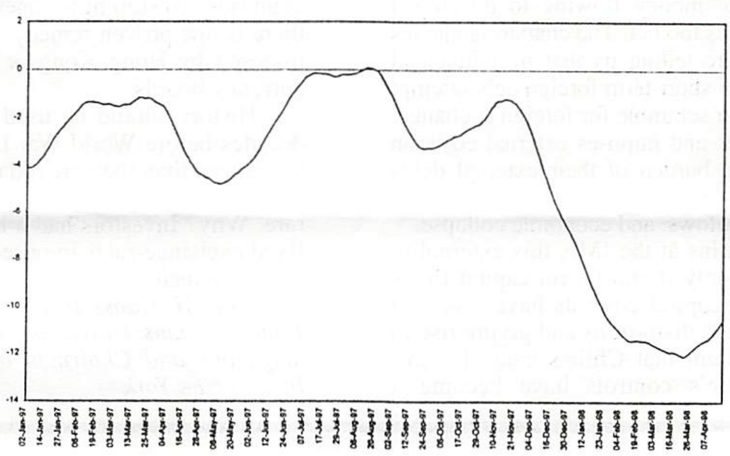


Chart 3 – Treasury Inflation Protected Securities

TIPS	SECURITY			BID	ASK	YTM
1)	TSY INFL IX	3 3/8	1/15/07	96-31	97-1	3.78
2)	TSY INFL IX	3 5/8	7/15/02	99-5+	99-7+	3.82
3)	TSY INFL IX	3 5/8	1/15/08	98-30+	99-0+	3.75
4)	TSY INFL IX	3 5/8	4/15/28	98-16+	98-20+	3.70

OBSERVER

The IMF and hot money

By Steve H. Hanke

With each financial crisis since 1973, the International Monetary Fund has proven adept at expanding its powers, budget, and jobs for the boys. Viewed in this light, the IMF's Managing Director Michel Camdessus had a point when he recently asserted that the IMF was "the most magnificent bureaucracy in the world."

What Mr. Camdessus didn't elaborate on was the role the IMF had played in causing international financial panics and crises. Just consider Indonesia, Southeast Asia's biggest basket case. With the encouragement of the IMF, Indonesia floated the rupiah on Aug. 14, 1997. But the rupiah didn't float. It sank.

In an attempt to stabilize the rupiah, Indonesia agreed to an IMF program in October 1997. The IMF moved quickly to close 16 banks in early November. This was a botched job, at best. Indeed, as a result, Indonesia became engulfed in a financial panic. Not only did the banking system melt down, but the rupiah went into freefall as private businesses attempted to cover their massive short dollar positions.

Then on Jan. 15, 1998, Indonesia signed an amended IMF agreement. It focused on far-reaching microeconomic structural reforms, but failed to address the cause of the currency crisis that had gripped Indonesia. Before the ink had dried on the amended agreement, the rupiah was in a freefall again, and from super-depressed levels.

The IMF's advice had left the rupiah in the tank, the economy insolvent, loads of inflation in the pipeline, unemployment on the rise, and unrest in the streets. What a record! Perhaps the IMF knows less about arresting financial crises than advertised. Indeed, perhaps it is part of the problem.

This brings us to last week's spring meeting of the IMF and the World Bank. The ever-opportunistic IMF was worried about too much misdirected private money flowing to developed countries and the fact that it was too hot. The chattering classes assembled in Washington were telling us that in a financial panic, companies with loads of short-term foreign debt attempt to cover their positions. In their scramble for foreign exchange, the domestic currency plunges and imposes external costs on other companies, because the burden of their external debts increases. This motivates even more short covering, further currency plunges, hot, money outflows, and economic collapse.

According to the mandarins at the IMF, this externality problem can be solved, but only if short-term capital flows are controlled. Even though capital controls have a dismal record, creating huge economic distortions and giving rise to corruptions, the dirigistes claim that Chile's controls have worked. Consequently, Chile's controls have become a mantra for the mandarins and yet another justification for the IMF to expand its powers. Is this warranted?

Since mid-1991, Chile has required foreign investments to stay parked in Chile for a minimum of one year. In addition, loans and bank deposits originating from abroad require a 30% deposit to be placed for one year at the central bank, without interest. This amounts to a tax on capital inflows, with short-term debt being hit with a higher implicit tax than long-term debt.

Chile's capital controls are simple and transparent. And they have been employed in Latin America's most free-market, corruption-free economy, one where the prudential regulation of the financial system receives high marks. Consequently, if capital controls are going to work, there is no better place for a test than Chile.

Have Chile's controls passed the test? Hardly. The record is mixed, at best. The controls have been only partially effective in controlling hot-money flows, and they have significantly increased the cost of capital in Chile. For example, Chile's borrowing costs are roughly double those in Argentina, where a currency board prohibits capital controls.

The chattering classes should start looking at the record before they jump to conclusions. Given Chile's less-than-stellar experience with capital controls, I shudder to think what would happen if officials in other developing countries were entrusted with the vast discretionary powers that go with capital controls. These powers would certainly not be used as disinterestedly as they have been in Chile.

If the chattering classes are interested in stopping hot-money flows, they should forget capital controls. Instead, they should focus on what causes the hot-money flows: the half-baked exchange rate set-ups used by most developing countries. To stop hot-money flows in developing countries, there is one proven remedy: fixed-exchange rates, like those imposed by Hong Kong or Argentina, both of which have currency boards.

History should be used to provide a guide. In the two decades before World War I, the capital markets were more globalized than they are today, investors were lending heavily to risky, emerging markets, and hot-money flows were rare. Why? Investors had a high level of confidence that the fixed exchange-rates imposed under the gold standard would be maintained.

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JAPAN

Too much gloom: a buying opportunity?

It is so thick, you can almost cut it with a knife. It is all the more remarkable as it is happening in a world awash with liquidity, hardly an environment conducive to finding bargains. We ask: Why should the world be so gloomy about Japan and so upbeat about, say, Korea and Brazil?

Economic statistics point unmistakably to a recession – whether in department store sales, down 20.5% from a year ago; or in industrial production, down 5.1% from a year earlier; or in employment, down 0.3% over the same period. Or whether it is the bulging inventory-sales ratio, with its ominous implications of more production cutbacks. Or finally, whether it is the fact that debts of Japanese firms that went bankrupt in the year to March 21 jumped 56.8% from the previous year, a record for a third straight year.

And yet, Japan is not an open-and-shut case. It is not a basket case like so many of the so-called emerging economies. It runs a gigantic current account surplus – and getting bigger by the day – somewhere between 2.5% and 3% of GDP. Its currency, the yen, while well down on its record high, reached in early 1995, is still up 7.7% from the beginning of the '90s, 85% from the beginning of the '80s, and a stunning 176% from the beginning of the '70s.

Yen bears should take note that at $/yen 130, Japan's export sector is quite profitable, a certain indication that the currency is not overvalued at these levels. And while it is true that its banking system is in miserable financial shape, it is also true that a significant safety net has been extended under this shaky structure. The nightmarish probability of a run on banks has effectively been forestalled, even at the cost of condemning the country to an inefficient banking system. Inevitably, though agonizingly slowly, tax reform is set to arrive; a significant corporate tax cut is almost certain to be proposed in the next few months.

Japan may not become a shining example of deregulation and liberalization, but even the old Japan was nothing to sneer at. All the more so with a few touches of reform in various key sectors of the economy, an independent central bank, a chastised Ministry of Finance, a global network of industrial corporations that have been busy moving out of Japan and establishing solid footholds abroad, the emergence next door of China, and with it, the cross-fertilization implicit in one of the largest two-way markets anywhere in the world.

Observers have focused their attention on cyclical problems, choosing to ignore the brightening secular prospects. This is not surprising, as the Japanese themselves have been worn down, financially and psychologically devastated by the seven long years that followed the bust of the Great Bubble.

There are only two paths out of the mire: the preferred one and the not-so-preferred one. The preferred one would have entailed biting the bullet, i.e., liquidating collateral, removing artificial props from under the real estate market, closing down banks. The second alternative would seek to inflate out of the problem, validating collaterals and bailing out the insolvent. And with it all, as we already mentioned, the number of bankruptcies have soared.

Japan has chosen the politically more palatable, but economically less efficient, second alternative: fiscal reflation backed by aggressive monetary reflation.

The fiscal measures now being proposed by the government – ¥16 trillion, including ¥4 trillion in temporary tax cuts – are large, but not unprecedented. On their own they would not be able to lift GDP by more than 1% for the year. What is truly unprecedented, however, is the extraordinary expansion in the Bank of Japan's balance sheet that has taken place over the past six months, an attempt, no doubt, to satisfy the liquidity requirements of the nation's wobbly banking system.

The increase in bank reserves, currencies, and consequently the monetary base, has temporarily been "absorbed" by the banks' need to replace withdrawals, although not completely, as Chart 4 shows. In effect, money supply would have contracted by now if the BOJ had not been as generous as it has in supplying reserves. (Sixty years ago, the Federal Reserve ignored this rising demand for reserves. As a result, the US money supply contracted by one third, aggravating the Depression.)

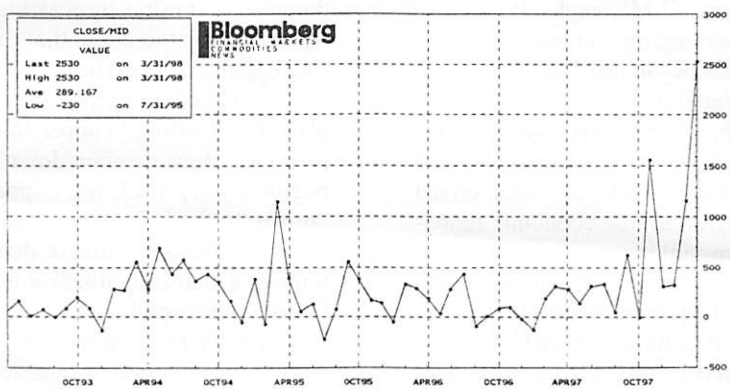
The essentially defensive nature of this balance sheet expansion can be observed by the refusal, thus far, of the money multiplier (broad money divided by the monetary base) to increase (see Chart 5). Having said that, we believe that at present, the increase in supply of reserves exceeds the demand, enough to cause the BOJ to intervene in the foreign exchange market and mop up excess funds. In fact it was rumored last week that the falling yen had caused the BOJ to intervene to the tune of $10-$14 billion, an indication that the Bank of Japan's balance sheet expansion has moved beyond its purely defensive character.

Sooner or later, as some semblance of confidence returns, leakages will abate and even reverse, and the money supply will expand at faster rates than 3%-5% per annum. We believe we've detected some signs of this happening already: When including foreign bank deposits, M2 plus CDs has been growing at about 1% higher than previously estimated. "There is no reason to handle the [foreign banks'] data differently from that of Japanese banks, and in addition, the amount of their deposits have been rising in recent years," the BOJ said in a statement.

We are in the early stages of a turnaround: The authorities are pushing on a string but are doing so with gathering force. The monetary juggernaut must be accompanied by a less-than-timid fiscal package that gives priority to permanent tax cuts. It will come.

STRATEGY: *It was a bit too early to sell JGBs. We were stopped out. It is so compelling a trade, however, that we will, soon, try again. Stand by. On the equities front, one can begin accumulating a select number of stocks of companies with healthy balance sheets, which enjoy the benefits of an undervalued yen, and which have already taken steps to improve their corporate governance.*

Chart 4 – Japanese Banks' Reserve Deviation



SILVER

Some glitter left

There is a dilemma facing those interested in the silver market. Here is a market that has experienced a tremendous breakout. It has broken through price barriers not seen in many years. It has done so against a backdrop of a general decline in commodity prices. On the other side, while a constructive case can be built for the balance between supply and demand, it is not overwhelmingly bullish. The case becomes even shakier when we submit that the main reason the market has gone up is that Warren Buffett, Chairman of Berkshire Hathaway Inc., bought 129 million ounces, and it becomes a buy-the-rumor-sell-the-news market.

Where do we go from here?

On the negative side, the very concept that made Mr. Buffett buy silver will work against it – it's just a matter of time. Mr. Buffett figured that if silver prices rose, the stagnant, almost nonexistent silver mining industry would become rejuvenated trying to produce as much silver as possible at prices that are profitable. To quote from the original press release: "...equilibrium between supply and demand was only likely to be established at a higher price."

Well, he made the price go up, and by some measures, his plan is working ahead of schedule. Late in February, CPM Group released a report stating that newly refined silver from all sources rose 5.8% in 1997 against a rise in consumption of 5.5%. But for 1998, they predict that supply will grow by 12.5% against growth in consumption of only 2.4%.

Further evidence of price hurting demand comes from India, home to the world's greatest friends of silver. Although the numbers are unclear, there have been reports from Indian refiners and distributers of silver that demand has dried up to next to nothing.

We find two positive factors, both technical, but potentially useful nonetheless.

First, on the morning of April 6 we were greeted with news that Mr. Buffett had sold a third, some said two thirds, of his 129 million ounces. Prices responded with a 27¢-an-ounce drop, but closed off the lows and worked their way higher in the coming days. It's a win-win situation. If he did sell so much silver, the market took it awfully well. The big selloff, in fact, came weeks earlier, as the market was almost a dollar lower. Possibly the selling by Mr. Buffett was done then and the market had already staged a magnificent recovery. On the other hand, if he did not sell any, and plans to treat his little investment in silver the way he handles his other holdings, then we have 20% of the world's silver supply unavailable for fabrication.

Then, we look to the open interest. As prices remain strong, relative to the range of recent years, we could blame speculative latecomers. In the past, a move in silver would attract a broad spectrum of speculators, large and small. In the post Berkshire Hathaway announcement days, we took on 20,000 contracts worth of that speculation. They're all gone now, as we sit with an extremely moderate 84,000 contracts. This open interest reading in conjunction with our other sentiment indicators shows little interest by the public, which means there could be much sidelined buying power.

STRATEGY: *We are friendly to the long side.*

-- Sholom Sanik

COPPER

The bear in waiting

The buildup of copper in LME warehouses that began last summer came to an abrupt halt at the end of February. Prices have mapped an inverse, but otherwise identical, course. Since the drawdown started, LME stocks have dropped by 75,000 tonnes. The pace of the movement of the metal out of the warehouses has accelerated, indicating perhaps that fresh demand has emerged. Prices started moving up almost to the day with the rapid depletion of LME stocks. Prices rose by about 13¢ per pound, representing the biggest rally since the current leg of the bear market began last June.

The copper market has matured from the shenanigans of the likes of the Sumitimo affair, when movements in warehouses stocks could not be relied upon as a test of supply and industrial demand. The recent bear market was characterized by movements in stocks that reflected true economic fundamentals. Production costs were sinking, and demand was waning. If we were to weigh our analysis heavily on warehouse stock movements, are we to assume as well that any or all of the very bearish fundamentals have changed?

The rally was sparked in part by talk that by the second half of this year Chinese importers would step back into the market. Understandably, when Chinese purchasing power becomes a factor, in this or any market, the bids and offers are headed northbound. Top government officials claim that infrastructure spending will accelerate this year as China shoots to maintain a GDP growth rate of 8%.

This scenario is supported by Asarco, which recently donned its mining forecasting hat again and is predicting tightness. Asarco claim that the Chinese used a very clever strategy that successfully deceived the market. China, they assert, created the impression that the market was oversupplied by "lending" copper to the market from its strategic reserves, thus driving down prices. As China now has begun to buy back the copper, it does so at a tidy little "profit," which Asarco claims is as big as $750 million. Asarco estimates Chinese demand in 1998 at 1.78 million tonnes, which is a rather robust and optimistic call but very bullish if accurate.

The other side of the coin is that little has changed. Even Asarco, which presents a basically bullish view and calls for higher prices, says that the mess in Asia will curtail demand in the 2-year period ending in 1998 by 400,000 tonnes. Even after the drop in LME stocks, and particularly if we add in Comex stocks of 110,000 tonnes, the stockpile is still huge by historical standards.

Down in Chile, statistics most recently available show the Chilean copper machine still cranking out the big numbers. Output for February was 269,211 tonnes, or 8.8% higher than last February. The amazing influence of technology on the efficiency of copper production that we detailed in our past two issues has not abated. It is likely to become an even greater factor as the technology spreads throughout the industry, pushing the cost of production lower.

The spreads in this market have gone for a bit of ride, moving from a $30/tonne carrying charge to a brief flirtation with backwardation. We view this spike in prices and the spreads in the context of a bear market rally.

STRATEGY: *We feel comfortable having sat out the rally and remain sidelined, but very interested in re-entering the short side.*

-- Sholom Sanik

COCOA

Fundamental forecast remains cloudy

The latest in a series of rallies in the cocoa market closed out with a three-session plunge that brought prices down $150 a tonne from the highs. As well, prices came perilously close to crashing through the bottom of the range that has thus far managed to survive what seemed to be some pretty serious bear market fundamentals.

With a carryout of 40% of consumption, the primary fundamentals remain bearish for prices. There have been a series of bullish stories that have kept this market supported. Most recently, reports from the Ivory Coast have shown that arrivals are running behind same-time-last-year arrivals, leaving a tightness in quality beans. We were expecting a crop that would be slightly larger than last year's 1.13 million tonnes – at one time analysts expected the crop to exceed even the record set in 1995-96 of 1.22 million tonnes. Unless the mid-crop comes through with the currently popular estimate of 200,000 tonnes, the Ivory Coast could have trouble reaching even last year's output.

A pattern of sorts has formed where we get positive angles for prices that are met with rallies, only to be quashed when the story fades and the reality of burdensome stocks emerges again. The net result has been the same, with prices going nowhere.

The action in this market has defied general, macroeconomic fundamentals. Almost without fail, prices of the major industrial and consumer commodities that we look at – cotton, crude oil, copper, meats, grains, lumber, sugar, etc. – have fallen from grace as the Asian crisis unfolded. Consumers of commodities in these countries were the cherished customers of producers that had become proficient, with constantly improving technology, in churning out more and more of the goods that were so in demand. Suddenly, disposable incomes took a dive as did the purchasing power of plunging currencies.

Cocoa prices should have been, one would think, near the top of the list, because it is still a luxury item in countries where monthly incomes can be as small as the price of decent haircut in London. Yet, put in the perspective of, say, a five-year range, cocoa prices are still quite expensive. With a low in 1993 of $850/tonne, a high in 1997 of $1,750/tonne, and a close this past Friday in spot July of $1,598/tonne, one could say that this market's participation in the great commodity bear market of 1997-98 hasn't been that great. It's either the last good short on the board or this market is sending a not-so-subliminal message that there is more bull in cocoa than meets the eye.

West African crops have more than made up for declining production in South America and Asia. Barring unforeseeable weather problems, supply should continue to grow. The issue was always and continues to be demand. The recently released first-quarter grind figures from the four key Western grinding countries were all up moderately and in line with analysts' forecasts. The Dutch grind rose 2.54%, the German grind by 1.26%, and the British grind by 3.84%. Finally, the US grind had the largest gain, at 3.93%.

What is significant about these figures is that they rose at all. Since the grindings in origin countries are now growing in earnest, it would be quite logical to expect a slowdown in grindings in the traditional grinding countries, if in fact there has been a slowdown in demand. Companies like Mars Inc. and Hersheys Foods Corporation do their own grinding and know what their needs are. If their grindings then truly represent consumer demand, and we add in origin grindings, then consumption is growing at a faster rate than production.

We may be eating into the 40% stocks-to-consumption ratio. It is hard to know exactly in this market. The information on the supply side is murky. Do the 50,000 tonnes or so that have not arrived at the ports in the Ivory Coast exist at all or are they being held back? Quite frankly, we don't know. These 50,000 tonnes could be the difference between yet another deficit year or a surplus season. On the demand side, as illustrated, we can no longer rely on the grinding data of the big four grinding countries as the sole source of consumption data. An organized reporting system for monitoring grinding data in origin countries has yet to appear.

For now, it is a trading affair, bound by $1,700/tonne on the high side and $1,450/per tonne on the low side. A breakout in either direction may initiate a trend.

STRATEGY: *Stay sidelined.*

-- Sholom Sanik

SOY COMPLEX

The untradeables, for now

Another series of record crops in both Americas and dwindling demand from foreign buyers have changed the dynamics of the soy complex this season. Or have they? Certainly in terms of soymeal, the demand for which was responsible for the growth of the soybean market, things have changed. Since last May, prices have been slashed in half to levels not seen since before demand from the countries of the Asian-miracle skyrocketed.

Bill Gary of *Price Perceptions* (April 18) maintains that "...farmers continue to expand production for a market that no longer exists." Although on the surface it would seem that the balance between supply and demand aren't much different than they were a year ago, a closer inspection reveals that the USDA is letting the bulls down easy.

In its latest supply/demand situation report, the USDA lowered bean exports again, but just by a smidgen, to 945 million tonnes. However, since domestic use was up, it also lowered ending stocks by 20 million bushels to 235 million bushels. Last year we had an identical pattern where ending stocks kept dribbling down bit by bit each month until they ended up at 131 million bushels. Make no mistake, this year is much different. While last year the USDA was underestimating exports in order not to shock the market, this year it is going in reverse.

Bill Gary points out that although actual sales are a bit ahead of the same period last year, outstanding sales are far behind. His arithmetic shows that in order to reach the USDA forecast for exports "...new sales must exceed last year by an astounding 122%," something that is unlikely to happen. The trend is not supportive, because the average export commitments for the last 4 weeks have been 221,000 tonnes, well below what is required to meet 945 million bushels.

Looking ahead to the new crop, on March 31 the USDA released planting intentions that showed US farmers will plant a record 72 million acres of soybeans. Because prices are still historically high, allowing them to lock in new crop at over $6.00 a bushel, why wouldn't they? If yields are similar to last year's 39 bushels per acre, we will have another record-size crop on our hands.

An easy short? Soymeal prices have taken as much of a beating as they're likely to for the moment. The risk of getting caught in an oversold market is large, because these bargain prices will bring patient buyers out of the closet. For that matter, soymeal export commitments have been the only bright spot in the complex in the past couple of weeks, averaging new sales of 320,000 tonnes, which is well above average weekly sales.

This brings us to the beans themselves, which are being governed by the forgotten cog in the wheel, soyoil. The fantastic strength in oil has been maintained even while we face tremendous new supplies from the South American harvest and the future threat of a record US crop. We kept hoping for a buying opportunity upon announcement of a lifting of the export ban of Indonesian palm oil. Well, the Indonesian government announced that the ban was being lifted, but then confused all players by also announcing that the end of the ban would be accompanied by a 40% export tax. Angry shouts from the IMF brought further confusing announcements. All this accomplished was to shift customers to a reliable supplier of vegetable oil, the US beanoil market. One could speculate that a good many customers were alienated enough to shift their vegetable oil needs permanently to beanoil. One could further speculate that a beanoil/palmoil premium will now become a constant.

Adding to palm oil's woes and boosting the fortunes of vegetable oil prices in general is further confirmation that Malaysia is having a poor production season. March palm oil production in Malaysia fell just a bit from February to 598,612 barrels, but dropped 12% from last March.

So while shorting beans may seem like a bright idea from a meal perspective, it must be tempered by the oil perspective. The monumental buildup in oil open interest makes this a very tricky market to play. One day soon, either the specs on the long side or the commercials on the short side will be caught.

STRATEGY: *We remain friendly but scared of the oil and neutral to beans and meal.*

-- Sholom Sanik

Chart 5 – Friedberg Capital Markets
Recommended current portfolio allocations

1. Various Short-Term Notes (US$)	17.5%	4. KIPT 9% cv (NZ$)	15%
2. US Trsy. Infl. Indx. 3.625% '28 (US$)	20%	5. Kgdm. of Sweden FRN '01 (US$)	32.5%
3. Argentina T-Bill (LETES) (US$)	10%	6. Trans Tasman 9% '99 (NZ$)	5%

Chart 6 – FOREIGN CURRENCY BONDS

DATE: April 16, 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		103.70	104.55	3.99		Oct-13
World Bank 9% 13/11/00 RRSP eligible		110.55	-	-		Nov-13
Argentina 8% 5/10/98		100.50	-	-		Oct-05
Kgdm. of Spain (6 Mo. LIBOR-1/16) 29/6/02 (semi)		99.89	100.19	-	3.75	Jun-29
CZECH REPUBLIC KORUNA BONDS						
General Electric Cap. Corp. 10.5% 23/10/98		96.45	-	-		Oct-23
Nordic Inves. Bk 10.625% 10/11/00		90.70	-	-		Nov-10
SWISS FRANC DENOMINATED BONDS						
General Electric Cap. Corp. 4 3/4% 2/7/98		99.65	100.50	2.12		Jul-02
General Electric Cap. Corp. 4 1/2% 17/12/99		103.20	-	-		Dec-17
DANISH KRONE DENOMINATED BONDS						
Kgdm. of Denmark 9% 15/11/98		101.95	102.80	3.84		Nov-15
ECU DENOMINATED BONDS						
United Kingdom 9 1/8% 21/02/01		111.85	112.70	4.26		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)		99.75	-	-	7.4375	May-27
CANADIAN DOLLAR DENOMINATED BONDS						
Ontario Province 10 5/8% 15/7/98 RRSP eligible		100.50	101.75	2.84		Jul-15
Petromet Resources 6.5% 31/3/04 (semi) CV @ $9.50 p/sh		91.50	-	-		Sep-30
SOUTH AFRICAN RAND DENOMINATED BONDS						
ESCOM 11% 1/6/08 (semi)		89.75	91.25	12.55		Jun-01
AUSTRALIAN DOLLAR DENOMINATED BONDS						
Toronto Dominion Bk. Aust. 7.25% 26/2/99 RRSP eligible		102.25	103.10	3.45		Feb-26
NEW ZEALAND DOLLAR DENOMINATED BONDS						
World Bank 8.25% 30/4/99 RRSP eligible		99.40	100.25	8.03		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)		98.20	99.05	8.81		May-24
Fletcher Challenge 10.15% 30/11/98 CV (semi)		98.90	99.75	10.55		May-31
Tranz Rail Ltd. 10% 15/10/99 (semi)		100.00	-	-		Apr-15
Trans Tasman 9% 27/6/99 CV (semi)		88.55 *	89.40	19.37		Jun-26
St. Luke 8.7% 1/4/99 (semi) CV @ 1.00 p/sh		143.80 *	145.80	18.74		Oct-01
Kiwi Income Prop. Trust 9% 30/9/03 CV (semi)		115.50 *	117.50	9.57		Sep-30
ARGENTINEAN PESO DENOMINATED BONDS	PAR VALUE			IRR		
Bocon Pre 1: 1/4/2001	101.0456	93.50	95.25	9.61		May-01-98
U.S. DOLLAR DENOMINATED FIXED CONV. BONDS						
Coeur D'Alene 6% 10/6/02 CV@ 26.00 p/sh		80.25	81.75	11.82		Jun-10
JumboSports 4 1/4% (semi) 11/1/00 CV @ 25.5 p/sh		33.25	-	-		May-01
The Learning Co. 5 1/2% (semi) 11/1/00 CV @ $53.00 p/sh		93.75	95.25	7.60		May-01
Novacare Inc. 5.5% (semi) 15/1/00 CV @ $26.65 p/sh		93.25	94.75	8.82		Jul-15
U.S. DOLLAR DENOMINATED FIXED RATE BONDS						
Argentina T-Bill (LETES) 0% 16/10/98		96.81	96.93	6.41		Oct-16
U.S. Treasury 6.25% (semi) 28/2/02		101.90	102.20	5.61		Aug-31
U.S. Treasury 6.375% (semi) 15/8/27		105.95	106.55	5.90		Aug-15
U.S. Treasury Coupon Strips 0% 15/2/25		20.00	20.30	6.03		Feb-15-25
U.S. Treasury Principal Strips 0% 15/2/25		20.00	20.30	6.03		Feb-15-25
World Bank 7 1/8% 27/9/99 (semi) RRSP eligible		101.70	102.55	5.25		Sep-27
Conn. Lt. & Pwr. 5.5% (semi) 1/2/99		99.10	99.25	6.49		Aug-01
Mobile Telecomm 13.5% (semi) 15/12/02		118.75	119.60	8.32		Jun-15
U.S. DOLLAR DENOMINATED FLOATING RATE NOTES						
Korea Exch. Bank FRN 27/6/98 3 mo. LIBOR +45b.p.(qtly)		99.30	99.45	-	6.1375	Jun-29
Canada Gov't 16/2/99 3 mo. LIBOR - 1/4 (qtly), callable @ 100 RRSP eligible		99.68	99.98	-	5.3750	May-13
Kgdm. of Sweden FRN 15/2/01 3mo LIBOR-12.5b.p.(qtly)		99.92	100.22	-	5.50391	May-12
Bocon 1/4/01 (30 day LIBOR) starts paying May 1,'97	PAR: 96.9053	95.50	-	-		May-01-98
Argentina: Series L:FRB 31/3/05, 6 mo. LIBOR+13/16 (semi)	PAR: 96	91.00	92.50	8.94	6.625	Sep-30
Venezuela: DCB: 18/12/07, 6 mo. LIBOR+7/8 (semi)	PAR: 95.2381	88.65	-	-	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, March 24, 1998:
Good afternoon for Tuesday, March 24. We have no changes or new recommendations. The new market letter is in the mail.

Wednesday, March 27, 1998:
Good afternoon for Friday, March 27. We have one new recommendation: Sell June Japanese government bonds, traded on the SIMEX or Tokyo Exchanges, at the market.

Flash Update: **Monday, March 30, 1998:**
Good morning for Monday, March 30, 9:30 am. This is a Flash Update. Sell June S&P at the market, presently trading at 1107.00.

Tuesday, March 31, 1998:
Good afternoon for Tuesday, March 31. There are no changes or new recommendations.

Flash Update: **Thursday, April 2, 1998:**
Good afternoon for Thursday April 2, 1:27 pm. This is a Flash Update. Cover short June S&P at the market, presently trading at 1125.00.

Friday, April 3, 1998:
Good afternoon for Friday April 3. There are no changes or new recommendations. The following is a recap of this week's recommendations.
- On Monday March 30, via Flash Update, we advised selling June S&P at the market, then trading at 1107.00.
- On Thursday, April 2, via Flash Update, we advised covering the short S&P at the market, then trading at 1125.00.

Tuesday, April 7, 1998:
Good afternoon for Tuesday, April 7. There are no changes or new recommendations.

Flash Update: **Wednesday, April 8, 1998:**
Good morning for Wednesday, April 8, 9:35 am. This is a Flash Update. Sell June Canadian dollars at the market, presently trading at 7032.

Flash Update: **Wednesday, April 8, 1998:**
Good afternoon for Wednesday, April 8, 2:35 pm. This is a Flash Update. Sell June crude oil at the market, presently trading at 15.80. And a reminder of our Flash Update from earlier today: Sell June Canadian dollars at the market, then trading at 7032.

Thursday, April 9, 1998:
Good afternoon for Thursday, April 8. There are no changes or new recommendations. The following is a recap of this week's recommendations.
- On Wednesday April 8, via Flash Update, we advised selling June Canadian dollars at the market, then trading at 7032.
- On Wednesday, April 8, via Flash Update, we advised selling June crude oil at the market then trading at 15.80.

Tuesday, April 14, 1998:
Good afternoon for Tuesday, April 14. There are no changes or new recommendations.

Flash Update: **Wednesday, April 15, 1998:**
Good morning for Wednesday, April 15, 10:40 am. This is a Flash Update. Buy June deutschemark at the market, presently trading at 5585.

Flash Update: **Thursday, April 16, 1998:**
Good Morning for Thursday, April 16, 10:20 am. This is a Flash Update. Cover short June crude oil at the market, presently trading at 16.15.

Friday, April 17, 1998:
Good afternoon for Friday, April 17. This is a complete summary since our last market letter dated March 22, of all liquidations of open positions and new recommendations that remain outstanding.
- On Wednesday March 27, we advised selling Japanese government bonds traded on the SIMEX or Tokyo Exchange, at the market. The JGBs opened on Thursday at 129.90.
- On Wednesday April 8, via Flash Update, we advised selling June Canadian dollars at the market, then trading at .7032, and selling June crude oil at the market, then trading at 15.80.
- On Wednesday April 15, via Flash Update, we advised buying June deutschemark at the market, then trading at .5585.
- On Thursday, April 16, via Flash Update, we advised covering short June crude oil at the market, then trading at 16.15.

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