

# FRIEDBERG'S

## COMMODITY & CURRENCY COMMENTS

Friedberg Commodity Management Inc.



Volume 19, No. 8 November 30, 1998

## The confidence game

*Confidence* adj.: of or relating to swindling by false promises. (*Webster's New Collegiate Dictionary*).

On November 13 the International Monetary Fund and other lenders announced a greater-than-life aid package to help Brazil bolster its currency. The package, which took a number of weeks to be put in place and which was preceded by innumerable leaks, was originally expected to amount to "only" \$30 billion. To lend drama to their rescue, the International Masters of Finance displayed a by-now-familiar pattern of one-upmanship and raised the bailout offer by a full 40%.

Out of the \$41.5 billion, the IMF was to advance \$9 billion almost immediately (even though Brazil still owned more than \$45 billion in international reserves, a far cry from the reserves exhaustion suffered by Korea, Thailand, and Indonesia just before their rescue) and as much as \$37 billion was to be uncharacteristically available in the first year, if needed.

To further impress the investment community, the package studiously avoided the traditional conditionality clauses that have formed part of every bailout effort to date. In effect, there was no defined set of quarterly monetary and fiscal targets that needed to be met before funds could be disbursed. In short, the package was designed to show that the real was impregnable, because Brazil could count on the full and unconditional support of the US Treasury and its allies, the IMF and the World Bank. It was designed to regain confidence, not, as in Mexico and Asia, to bridge pressing foreign exchange commitments. The International Masters of Finance had widened their activities: They would henceforth engage in confidence games.

Here is how the lenders – and Brazil – intend to play the game: A package of fiscal measures is supposed to generate a primary surplus (revenues minus expenditures, excluding interest on the debt) of 2.6% of GDP in 1999, 2.8% in 2000, and 3% in 2001. Allowing for some legislative slippage, these targets may be feasible were it not for the fact that the country has entered a severe recession.

The more serious problem, however, lies with the interest cost on the ballooning domestic debt. The debt now stands at around US\$300 billion and compounds at rates in excess of

34% per annum every few months, even after rates climbed down from the August peaks of 40%-plus. This year's fiscal deficit will easily exceed 8% of GDP, despite a minuscule primary deficit (0.1%), all of it a result of interest expenses.

Why are domestic interest rates so high in the face of almost zero inflation? For one thing, meager domestic savings, increasingly reliant on (now reluctant) foreign flows (the deficit on current account equals 4% of GDP), exacerbated by continuous government borrowings. For another, an ever-present foreign-exchange risk. While the real is being devalued by approximately 7.5% per annum (a crawling peg), the highly sensitive and dollarized domestic market has begun to build in the possibility of a greater-than-30% devaluation.

Given the importance of interest costs to the fiscal balance – and to confidence in general – international official lenders and the Brazilian government have concentrated their rescue efforts on the achievement of substantially lower interest rates in the ensuing months and years, through reducing/eliminating foreign-exchange risks and through closing the fiscal gap. Official projections target interest rates of 25% for the end of this year and 20% for the end of next year. At best, these rates would stabilize the debt-to-GDP ratio at an unacceptably high 47%, considering Brazil's historically low monetary credibility and the extremely short profile of the debt.

The best-case scenario, then, is that Brazil is able to lower

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Contributions by Albert D. Friedberg, Steve H. Hanke, and Kenneth R. Timmerman.

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

interest rates without suffering undue foreign exchange losses. Using smoke and mirrors, Brazil pretends to enter into a virtuous cycle of lower interest rates, falling deficits, even lower interest rates, and finally, fiscal balance.

That is not to be. Choked by astronomic interest rates – it is reported that consumers pay 175% per annum to buy appliances – a rate in line with the 12.4% per month charged by MasterCard users – economic activity has taken a sharp dive. Real GDP in the third quarter shrank by an annualized 6% compared with the previous quarter, while unemployment has already climbed to 7.6% at the start of the contraction, a much higher rate than at the start of every other recessionary cycle in the past 20 years.

JP Morgan economists have pointed out that the unemployment rate has risen by 2 points during the past year, when the economy was growing by about 0.5%. Estimating next year's GDP fall at 4.3%, they conclude that the jobless rate could climb by about 4 points. Clearly, Brazil will not be able to put in place the proposed fiscal package. This is perhaps the reason that the IMF offered funds without attaching strict fiscal and monetary quarterly targets: The need to "flexibilize" them was too obvious and too imminent. The risk attached to fiscal flexibilization in mid-course was all too apparent. Better, it was thought, not have any targets and claim that everything was going as planned. An essential part of the confidence game.

Even if Brazil was not entering its most severe recession in 20 years, the fiscal program – constructively called fiscal reform – was a non-starter. Less than 50% of it is accounted by spending cuts of less than 6.3% of next year's budget. This is hardly inspiring when one considers that Brazil's public sector expenditures shot up to nearly 40% of GDP from about 30% before the current stabilization plan in 1994.

The country's overspending addiction has been fed by rising taxes: from 26% of GDP to 31%. Is Cardoso an enlightened governor as he is made out to be by an adoring foreign press, or just another Big Spender? Helped by a relatively efficient tax collection system, Big Government has managed to cripple the Brazilian economy. Cardoso's fiscal reform will just spell more taxes and, at best, a stabilization of the already grotesque level of fiscal expenditures.

Under the best of circumstances, i.e., freely flowing and abundant foreign capital, Brazil's economy can no longer grow. If it can no longer grow, foreign capital will flee. Instead of the vaunted virtuous cycle, Brazil enters a deadly vicious cycle. External constraints call for private and public austerity; in the absence of cooperation from the public sector, the private sector collapses.

The IMF/Brazil plan is different, very different, from all previous bailout and stabilization packages. It shuns monetary adjustment – and in fact it promotes renewed credit expansion if the market permits it – in favor of a typical more-taxes/some-spending-cutbacks fiscal adjustment.

In fact, the IMF provides Brazil with the financing necessary to *ease* monetary conditions. The mathematics are relatively straightforward: The external financing gap, made up

of the current account deficit and debt amortization, is expected to amount to US\$54 billion. The first year portion of the aid package is \$37 billion. Add to this the hope that lenders are expected to extend a substantial portion, but not all, of the accruing interest, which could amount to \$15-\$21 billion, and the financing gap is closed.

This simplified math does not consider positive/negative flows deriving from foreign direct investments (including privatizations) and portfolio investments. In view of present economic prospects, we are inclined to believe that investment flows will be negative. More importantly, if confidence is not restored, domestic real holders could become the decisive players in this drama. More specifically, broad money supply in Brazil amounts to 224 billion reals, or approximately \$187 billion. This amount looms large in relation to the external gap. High interest rates have dissuaded real holders from converting to US dollars. As we near the end of the confidence game, these holders will lose their nerve and run to the bank. The delicate external gap will come under pressure. Brazil will be forced to devalue after having suffered through a savage austerity program. All the effort for naught.

There is a better way. Brazil must come to realize that it is being sacrificed on the altar of world stability. The international lenders care little about Brazil's unemployed and about Brazil's future prosperity. What they do care about is the potential domino effect – in Latin America and, by contagion, North America and Europe – that a devaluation of the real can bring about.

Brazil must come to realize that its currency is overvalued and that high interest rates are largely a result of devaluation expectations. These expectations will persist as long as the market perceives that the international lenders and Brazil are engaged in a confidence game.

What should Brazil do? It should stop playing games. It should devalue by an amount that will validate market expectations, possibly 30%-35%. It should immediately institute a currency board. Brazil's present international reserves, at \$42 billion (not counting the IMF aid package) comfortably exceed the monetary base (\$28 billion); a 35% devaluation will reduce the monetary base to a mere \$18 billion, allowing Brazil to run the world's second (to Hong Kong) most impregnable currency board and far surpassing the cover of the highly successful Argentinian currency board.

Next, having already legislated the crucial social security reform, it should cancel all tax increases and announce a deeper cut in expenditures. The quick fall in interest rates – produced by a genuine change in expectations – should close the fiscal gap at a far faster rate than ever dreamed by the IMF technicians.

The current IMF/Brazil plan is nothing less than a confidence game, with confidence in the adjectival sense of the word. Like all confidence games, it must come to be exposed, with tragic consequences for Brazil and for world stability. There is, fortunately, a better way. The sooner Brazil realizes it, the better. Either way, bet on a devaluation.

**OBSERVER**

## The current account threatens Goldilocks and the greenback

by Steve H. Hanke

The US economic boom has been remarkable: above-trend GDP growth; record-low unemployment rates; a strengthening dollar; a falling inflation rate; and bull markets for financial assets. Yes, there have been anxious moments: the Asian crisis; the collapse of the ruble; and questions about Brazil's stability. Despite these concerns, the spinmeisters tell us that the international trouble spots are on the mend and that we have turned the corner. Indeed, the financial press is upbeat. America's Goldilocks economy is alive and well, everything is just right. But is the current happy state of affairs sustainable? In a word, the answer is "No."

Inflationary pressures that usually accompany a boom in domestic demand have to a large extent been diverted abroad by a strong dollar and a widening of the current account deficit. Meaning that, on balance, the US is importing more goods and services than it is exporting, net of investment income and unilateral transfers. This deterioration in the current account balance and its consequences have gone largely unnoticed. It's time to take a look. In economics, growing imbalances don't go on forever.

The US experienced very large current account deficits in the mid-1980s, following the dollar's strength and overvaluation in 1984 and 1985. The current account deficit peaked in 1987 at \$168 billion, or 3.5% of GDP. This imbalance was corrected by dollar weakness and a slowdown in domestic demand in the late 1980s and the recession of 1991, when the current account deficit narrowed to only \$4.4 billion.

Since 1992, the current account deficit has widened dramatically. In 1997, it stood at \$155.2 billion and is projected to widen to \$236 billion this year. For 1999, the gap is projected to be \$300 billion, or about 3.5% of GDP, a percentage that would match the high of 1987.

These alarming forecasts have a certain credibility. First, the so-called Asian flu will hit the US hard. Indeed, the Clinton administration has already signaled that it will do its part to stabilize the Asian economies by allowing the US to act as the "importer of last resort."

Secondly, demand conditions in the world's first and second largest economies, the US and Japan, are in marked contrast with each other. US domestic demand is still growing well above trend, at about 4% per year, while Japanese demand is contracting. Consequently, the underemployed Japanese economy will continue to produce and ship increasing amounts of exports to the overemployed US economy.

Thirdly, the delayed response to the dollar's appreciation, which began in mid-1995, is bound to curb US export volumes

and stimulate imports for the remainder of this year and 1999.

Finally, the value of foreign investments in the US exceeds the value of American investments abroad. Consequently, there is a net outflow of payments to foreigners, and these add to the current account deficit. In 1997, the first year of these outflows, payments to foreigners amounted to \$5.3 billion.

There, of course, is nothing inherently wrong with a current account deficit as long as foreigners are willing to finance it. Indeed, the flip side of a current account deficit is simply foreign capital inflows. And since the US current account deficit began to swell in 1992, foreigners have been more than willing to buy financial assets in the US, even in the face of an appreciating dollar. In 1996, foreigners snapped up a record \$232.2 billion in US bonds, and in 1997, \$184.2 billion.

Although the pace of net Treasury purchases slowed to \$40.4 billion in the first six months of 1998, it has been made up, in part, by foreigners' increased appetite for corporate bonds and equities. Since 1994, foreign purchases of US corporate bonds increased by 121% to \$84.3 billion in 1997, with another \$66.6 billion purchased in the first half of 1998. And since 1994, US equities purchased by foreigners shot up by an astounding 3,379% to \$66.1 billion in 1997.

Absent a continued bull market in US assets, this leaves us with a troubling question: How will the growing current account deficit be financed? Indeed, where can foreigners hope to find the juicy returns needed to entice them to ship record amounts of capital to the US? Absent a marked slowdown in US domestic demand – something the Fed is fighting against – and a consequent narrowing of the current account deficit, there is only one avenue to enhance prospective returns on US investments for foreigners: a weaker dollar. A weaker dollar makes US assets cheaper. And an eventual post-adjustment turnaround and appreciation of the dollar would add to future foreign returns.

Goldilocks' appetite has gotten the best of her. Goldilocks has to stop bingeing. The economy has a problem: the growing current account imbalance and its flipside, the need for foreign financing. The strong dollar is vulnerable and will eventually give way to weakness. Indeed, it's only a matter of time before the strong dollar is called to take a final bow in the Goldilocks story.

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**INFLATION WATCH****Financial socialism**

Swinging wildly between the extremes of irrational exuberance and credit deflation, the world economy has come to resemble a foundering boat in a stormy sea. Unlike, however, our unfortunate representation, this state of affairs is man-made.

Credit inflations, created by central banks via an arbitrary injection of reserves – literally out of thin air – into a profit-maximizing banking system will sooner or later extinguish themselves. That is, if they are not kindled further. The reason is relatively simple: Credit inflations repress the true cost of money, encouraging poor and highly speculative investment decisions. As these projects begin to falter, lenders incur losses. Lenders become more cautious (the famous repricing of risk) and interest spreads widen. This widening causes more losses as borrowers find it increasingly more difficult to service and to roll over existing debt. Banks may call in loans in an attempt to build up excess reserves, households may increase their cash reserves with an attendant effect on banks' loanable capacity. Business failures reinforce the repricing of risk, throwing in reverse the free nature of the previous expansion. In effect, a credit contraction is in progress. This is how, in the pre-Greenspan era, credit excesses were purged.

Ever since Alan Greenspan became the chairman of the world's most powerful and influential central bank, an insidious form of financial socialism has distorted the natural rhythm of credit fluctuations. Credit inflations could merrily be created, but heaven forbid, they mustn't be allowed to go into reverse. In the name of averting a credit crisis – or the more ominous sounding systemic risk – the Federal Reserve has rekindled time and again the faltering fires of a credit expansion.

In all these 15 years, the Greenspan Fed has never taken responsibility for the speculative orgy that has blanketed the planet, nor has it seen any connection between, for instance, the emerging market mania, the stock markets bubbles, the Asian boom-bust cycle, the consumer blowout, and its own actions. Each event, and each crisis, was the product of some specific ill, totally unrelated to the its own doings. In fact, at each critical juncture, it was only the Fed's good sense and even wisdom that could save the day – by further reigniting the credit inflation!

Thus, from staring with terror at the abyss in late summer, we now allow ourselves – just two months later – to indulge in an exhilarating ride on internet stocks, totally oblivious of financial risk. While interest rate spreads have still not returned to their glory days, the market is

quite certain that the Fed will not spare any effort to lull us back into complacency. Such is power of the Greenspan Fed. Such is the power of this new financial paternalism, or might we dare say, the new financial socialism.

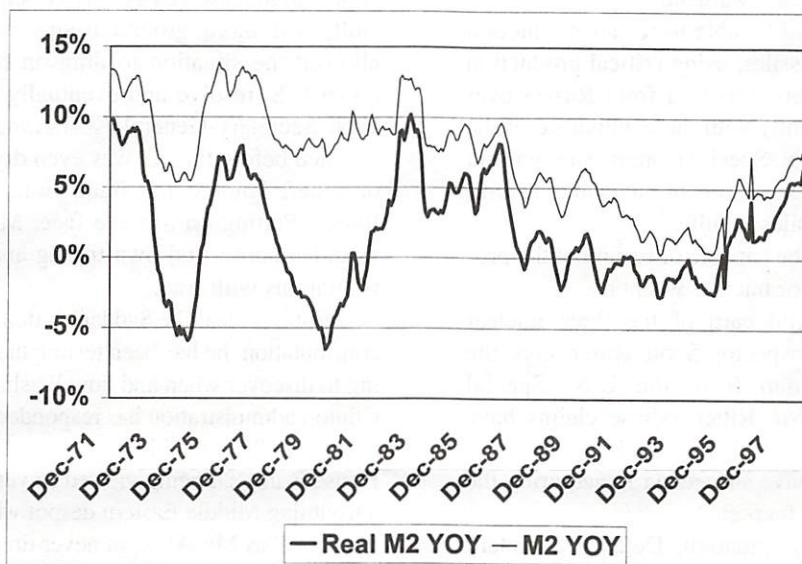
The wild and rapid swing from complacency to terror and back to complacency in such a short span of time (two-and-a-half cycles in a mere 16 months – July '97 to November '98) should bring us back the image of a foundering boat. But, one may ask, can't the Fed continue to reignite the cycle at each turn, lowering rates and expanding money, at will? Can it continue doing so with impunity? No, and no.

In each attempt to reflate, the Fed increases the system's moral hazard. Sure of being bailed out, the financial system increases its leverage ratio, risks and volatility soar, and the odds of a fatal accident rise exponentially. A stock market crash from the Dow 3,000 level is far less damaging than a crash from the 9,000 level, and much less than one from the 12,000 level. Financial intermediaries were nearly decimated in the August selloff because of the immense leverage and risk latent in their balance sheets. The Fed was lucky to stave off the unravelling of Long-Term Capital Management LLP, but will it be so lucky the next time? The swings of our imaginary boat become so uncontrollable that the boat does not founder – it merely breaks from the impact.

Can it inflate with impunity? Of course not. The accelerating growth of money supply (see Chart 1) spells trouble. Broad money supply (M2) has been growing at 9% annualized for the past 6 months and 15.4% for the past 2 months, a truly astounding pace. In real terms, M2 has been growing at the fastest rate in decades. An October Federal Reserve Bank of St. Louis publication has suggested that on the assumption that velocity stayed at the same level as it has since the first quarter of 1995, M2 growth of 7% would spell an inflation rate of 4.5%. The much higher recent rates of growth, of course, would spell disaster. The Fed would lose its much vaunted maneuverability – and credit deflation would set in.

The Fed's recent easing moves have ratcheted up the stakes. As the US economy slows down, the dictates of the new financial socialism will bring us lower short-term rates and even faster rates of growth in money and credit. It will be a race against time: If a catastrophic financial accident is avoided, inflation will "punish" the Fed. In the end, we will not escape the inevitable credit deflation and its painful aftermath: a business depression.

Chart 1



## FOREIGN AFFAIRS

# Saddam's deadly timetable

By Kenneth R. Timmerman

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We reproduce the following article for two reasons. For one thing, the Iraqi situation may someday have a dramatic impact on world oil prices. This may happen in the not so unlikely event that Saddam Hussein unleashes weapons of mass destruction on a number of oil-producing patches in an attempt to gain military and economic control over the region. One could well imagine that a decisive allied response may be agonizingly slow in coming, fearful of further Iraqi attacks on populated centers. In the meantime, oil prices would skyrocket.

More importantly, the article underscores the inability of Western democracies to seriously cope with important issues – not unlike the way they deal with matters of finance and economics, the Western democracies seek cosmetic solutions to problems that require unpopular and realistic decisions. Typically, they will postpone the inevitable hard choices to the last possible moment, unnecessarily increasing pain and cost.

Iraq's decision on Saturday to halt all cooperation with United Nations arms inspectors comes as no surprise. For the past year Saddam Hussein has been warning that he would toss out the inspectors if the Security Council refused to lift sanctions on Iraq – sanctions that are in place precisely because of Saddam's refusal to cooperate with the arms inspectors in the first place. But the crisis now beginning to unfold is far more serious than anything the world faced since Iraq's August 1990 invasion of Kuwait. Saddam's declaration on Saturday starts the clock that all the arms experts have been warning about for five years: Day One of Saddam's weapons deployment schedule.

Until now, all the estimates of how long it would take Saddam to develop nuclear weapons, rebuild his capacity to produce chemical weapons, or deploy his ballistic missiles have been pegged to the end of U.N. inspections. Just last January, CIA director George Tenet said that Iraq could resume production of biological weapons "very, very quickly, in a matter of weeks" and would be able to assemble missiles capable of carrying those weapons to Israel within a few months. Mr. Tenet concluded that "Iraq retains the technological expertise to quickly resurrect its weapons of mass destruction, if the U.N. inspections were ended." Well, those inspections have ended.

From public statements by administration officials and interviews with former weapons inspectors, it is possible to estimate Saddam's timetable:

- Within days of the end of inspections, he will be able to deploy biological warfare agents, including anthrax spores, which were produced before the Gulf War and stored in stable form. Iraq is known to have converted agricultural aircraft and unmanned drones in recent years, fitting them with special sprayers to deliver anthrax spores. He could use these over staging areas in Kuwait, Qatar, and Saudi Arabia where the U.S. has pre-positioned military gear, severely limiting, if not prohibiting, a U.S. deployment such as Desert Storm.
- Within weeks, Saddam will be able to take hidden missiles out of storage and fit them with biological and chemical warheads. The U.N. has just confirmed that he was pro-

ducing VX nerve gas in large quantities prior to the Gulf War and packing it into missile warheads.

- Within months, Saddam will be able to restart production lines to build additional missiles, using critical production machinery and guidance sets imported from Russia over the past three years, apparently with the connivance of the Russian authorities. The U.N. Special Commission on Iraq believes Saddam has enough equipment on hand to assemble several dozen new missiles rapidly.
- Within two years, Iraq will be capable of resuming the production of fissile material for nuclear weapons.

Added to this is the wild card of the three nuclear weapons the former U.N. inspector Scott Ritter says the Iraqis have built and hidden from the U.N. Special Commission. According to Mr. Ritter, whose claims have never been contradicted, Iraq is lacking only the fissile cores for these weapons and may have succeeded in acquiring the nuclear material on the black market.

Faced with this alarming situation, Defense Secretary William Cohen on Saturday cut short a trip to Asia and returned to Washington, and Secretary of State Madeleine Albright went to the U.N. But on Sunday, the Pentagon announced that U.S. forces in the Persian Gulf had not been put on alert, and that there were no plans to move additional forces to the region beyond the USS Eisenhower and its carrier battle group, currently steaming in the Arabian Sea. Said Mr. Cohen: "We prefer to act through our allies and with our allies if we have to take any action at all."

Saddam has understandably concluded from President Clinton's empty threats over the past five years that the U.S. will not punish him in any meaningful manner as long as he doesn't openly threaten Israel or Kuwait. In 1993, when Iraqi agents were caught red-handed in a plot to assassinate former President Bush during a trip to Kuwait, Mr. Clinton responded by launching cruise missiles against an intelligence headquarters in Baghdad – but first made sure that all the intelligence agents had gone home for the night. In August 1996, Saddam crushed U.S.-backed rebels in the northern city of Ibril, massacring several thousand opposition fighters and causing thousands of others to flee. The U.S. stood by, responding only with another cruise-missile strike – at a few air defense sites south of Baghdad.

In October 1997, when Saddam first called a halt to the U.N. inspections, the Clinton administration appeared set to

respond more vigorously. F-117 stealth fighters were deployed in Kuwait, two carrier battle groups were sent to the Gulf, and more ground troops were dispatched. Saddam allowed the situation to drag on for four months, wearing down U.S. resolve and eventually working out a deal with U.N. Secretary-General Kofi Annan that the Iraqi dictator violated before the ink was even dry. The U.S. heaved a sigh of relief, ignored the Iraqi violations and drew down its forces. Putting on a brave face, Ms. Albright said the U.S. would "choose [its] own timing and terrain" for future confrontations with Iraq.

But it is clear the Saddam is doing the choosing. With each confrontation, he has been testing the resolve of the U.S., probing to discover when and how Washington will react, while the Clinton administration has responded like a bunch of volunteer firemen. What should be setting off alarm bells at the White House is instead being viewed as yet one more provocation by a troubling Middle Eastern despot who needs to be put back in the "box," as Ms. Albright never tires of saying.

The U.S. does not need additional Security Council resolutions to take military action against Iraq; Baghdad is in material breach of all its commitments under the cease-fire resolutions. But the Clinton administration is using the U.N. the same way it uses focus groups, as a way of sounding out public opinion to tailor its actions to the popular mood.

Over the next few days, the U.S. should mount serious offensive strikes, using manned aircraft, helicopters and eventually special forces teams, against key Iraqi weapons facilities. Next, the administration should order the Pentagon to spend \$967 million authorized by Congress to train and equip and Iraqi Liberation Army under the leadership of the broad-based Iraqi National Congress. Saddam's political base inside Iraq is eroding, as the success of the INC in the past has shown.

Britain and most of American's European allies will join in supporting vigorous military action; so will friends in the Persian Gulf – if they sense that Washington has finally gotten serious about helping the Iraqi opposition get rid of Saddam. But if the U.S. continues to dither, Saddam will break out of his box for good – this time, armed with the most deadly weapons of all.

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