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The inevitability of a stock market crash

While credit spreads point the way, the Fed prepares the public

Markets that move in response to specific news are far less interesting – and carry far less significance – than those that move for no particular reason. Over the past four years, and in quickening succession, Mexico, Southeast Asia, Russia, and Brazil shook the financial world, causing dramatic corrections in stock and debt prices. While astute observers have known for years that problems were bound to crop up in many parts of the world, the exact moment of their appearance and the speed of the developments took many by surprise. In that sense, the ensuing market trends followed the news.

Tranquilizing injections of cheap money and official reassurances – in words and in deed – that all was well after all, calmed the world's major financial markets. The successive bailouts, however, exponentially encouraged the taking of more risk, particularly in the US. Unwittingly, the risks of another blowout were being transferred from the emerging world to the pillar of the global economy. "Fraying at the edges" is the way we characterized the process of financial disintegration more than two years ago (see our April '97 issue).

Unfortunately, we have moved center stage. As former Fed Chairman Paul Volcker summed it up, "The fate of the world economy is now totally dependent on the stock market, whose growth is dependent on about 50 stocks, half of which have never reported any earnings."

There will not be a single event that will cause markets to implode. Rather, a persistent erosion will raise fear levels until a panic ensues. The erosion is the trend, the panic will be the news. The erosion has already commenced: Swap, or TED spreads, have widened dramatically in recent weeks. These spreads represent the yield difference between an interest swap (itself a measure of market expectations of the average rate at which an A/AA bank can borrow funds over a specified period, which could be as short as one month or as long as 30 years) and a comparable maturity government bond. The spreads are an excellent proxy for investor fears and concerns about credit.

A look at Chart 1 tells the story: Absolute spreads have widened to the highest levels in 10 years, exceeding those reached at the height of the S&L crisis, on the eve of the 1990 recession. Given today's much lower level of interest rates, relative spreads have widened even more dramatically.

For some background to this re-rating of credit concerns, one need not go too far. Despite a record nine-year economic expansion, defaults by sub-investment-grade companies in the US are rising sharply, and credit quality is reaching the lowest point so far this decade. According to Moody's Investors Service, the 12-month trailing default rate, based on number of issuers, has surged to 4.55% as of the end of the first half. To put matters in perspective, this compares with a default rate as low as 1.48% for the 12 months ended May 1997.

The stock market itself has shown a steady internal erosion, despite excellent corporate profits. Breadth in the NYSE and Nasdaq has fallen to new lows, extending multi-year declines in the face of new index highs. Sooner or later this trend will lead to more sustained selling. Eventually, a selling panic – and a full fledged financial crisis – will result.

The Fed has an extremely unpleasant task at hand: deflate the bubble without causing too much pain. Chairman Alan Greenspan's most recent remarks have emphasized the fact that the Fed will eventually be able to cushion the effects of the crash. "Should an asset bubble arise, or even if one is already in train," he allowed at the Humphrey Hawkins testimony of July 22, "monetary policy properly calibrated can doubtless mitigate at least part of the impact on the economy." Maybe yes, maybe no. But at any rate, in this and in previous remarks

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Contributions by Albert D. Friedberg, Steve H. Hanke.

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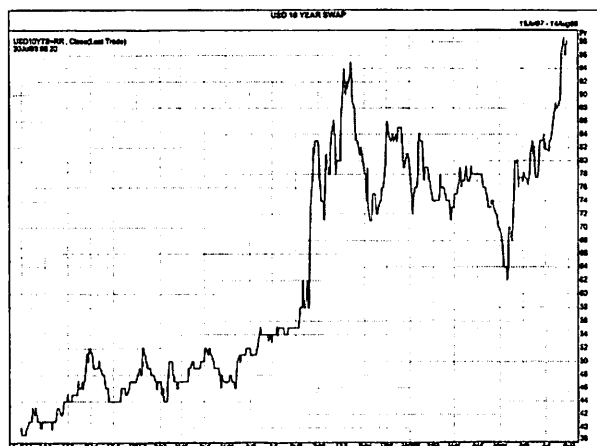
(see our analysis on page 3), Greenspan has strongly intimated that a crash is a foregone conclusion.

The persistent widening of credit spreads and the extraordinary weakening of internal market strength occurring without a specific news item to trigger them – and, worse yet, against a booming economic background – have to be taken seriously. Fear is returning. Unlike what happened in 1997 and 1998, there is no specific country or regional event on which to place the blame. For this reason alone, the simultaneous deterioration in debt and equity markets is more significant.

It is clear to us that markets are sensing the growing fragility of our overleveraged financial system. Coupled with this, they are sensing that the Fed has finally decided, for its own reasons, to sober up investors (see our nearby analysis). Sophisticated investors realize that a sustained period of monetary tightening in response to growing inflationary pressures will wreak havoc with global financial markets. They have begun to take protection. By doing so, however, they will bring about their worst fears. In many ways, what is about to unfold is very similar to what occurs during a run on an insolvent bank: Those who panic early are assured of being made whole; latecomers suffer varying losses of principal. Some will even walk away empty-handed.

What is one to do? Sell stocks. Redeem mutual fund units, because they will not be able to honor redemption requests in the late stages of the decline. (Are their net asset values realistic? Who will buy their illiquid shares at the stated closing prices? The 1999 version of a massive run on banks?) Hold inflation-linked Treasury securities and prime, investment-grade, short-term debt only. Hope for a soft-landing, but prepare for the worst.

Chart 1



THE ECONOMY

The inflation front: productivity increases will not be enough

Though we place little weight on the type of statistics that are derived from national income accounts (or for that matter from figures that are extrapolated from sampling surveys), one should harbor little doubt that productivity has been on a tear. Proof of it is the scintillating second-quarter result of corporate profits.

Fed Chairman Alan Greenspan has been quite conscious of this bonanza – and quite concerned at the possibility that productivity would not continue to accelerate. “Once output-per-hour growth stabilizes, even at a higher rate,” he said in his last Humphrey Hawkins testimony, “any pickup in the growth of nominal compensation per hour will translate directly into a more rapid rate of increase in unit labor costs, heightening the pressure on companies to raise the prices of goods and services they sell.” In fact, his obsession with this phenomenon led him to mention “productivity” no less than 37 times in the prepared text of his remarks, more than any other economic measure (prices were cited 27 times, inflation 15 times).

And obsessed he should be. The Fed’s monetary performance has bordered on the reckless. As we have shown in previous issues (see, for example, our May 30, 1999, issue: “The truth behind what drives US monetary policy: what *is* is not what appears”), money supply has been allowed to grow at rates that are incompatible with price stability. Fortunately, productivity increases have been inordinately strong, offsetting, at least temporarily, the inflationary implications of this monetary misbehavior.

The 1996-98 collapse in commodity prices, caused primarily by the Asian economic downturn, also had a significant impact in restraining worldwide consumer price inflation. Had the Fed continued to exercise moderation in monetary management (M2 growth was on a downward trend from 1981 to 1994, see Chart 2), it is clear to us that consumer prices would have *fallen* for the past four years.

While we profess total ignorance on the subject of productivity, we do know one or two things about commodity prices. And what we know should give the Fed Governors some sleepless nights: Commodity prices have stopped falling. As an example, the year-on-year fall of the widely watched Journal of Commerce Industrial Index has narrowed to less than 2%, from more than 14.7% at the nadir of the Asian crisis (see Chart 3). The Commodity Research Bureau Index, more heavily weighted towards crude oil and thus less representative, has given every indication of bottoming out, having recently tested successfully the February lows. More significantly, a diffusion analysis of its components reveals a greater internal strength than suspected, leading us to believe that we have entered the early stages of a commodity bull market.

The Fed is staking its reputation on a fickle and hard-to-measure economic variable, productivity, *over which it has no control*. It would be far better advised to pay attention to the one variable over which it *does* have control: the growth of its own balance sheet. Money, Mr. Greenspan should know, not productivity, will dictate the long-run behavior of inflation.

Chart 2

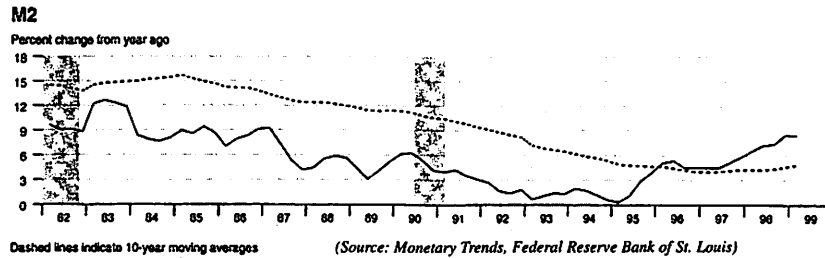
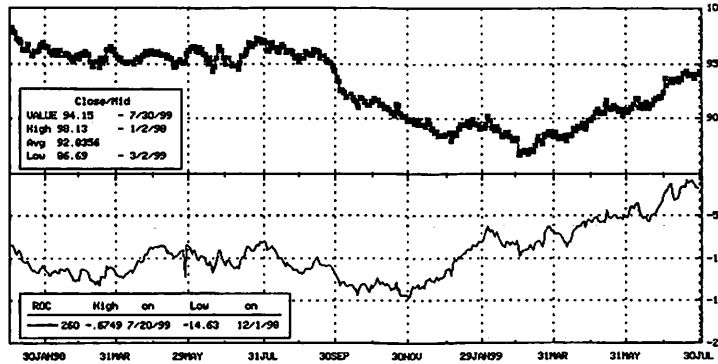


Chart 3
JOC Index
Year-on-year change



THE FED

Greenspan serves notice: Here comes the crash

A version of this article appeared in the June 22 edition of the National Post.

Has Alan Greenspan finally signalled the end of the party? We think so. A paradigmatic shift has occurred in the Fed chairman's thinking, a watershed in monetary policy-making.

Before we dissect his carefully crafted June 17 testimony to the Joint Economic Committee, we should note that Wall Street does not share our opinion. In fact, bond and stock markets rallied with gusto, relieved that a modest quarter-point tightening was all that was going to be. This was inferred from his statement that "when we can be pre-emptive, we should be, because modest pre-emptive actions can obviate the need to more drastic actions at a later date." Even on their interpretation, however, one ought to pay attention to the calculated use of the plural "actions." Will it be a number of quarter-point actions?

That Mr. Greenspan is gravely concerned with stock market and real estate speculation is undeniable. His speech is littered with such references. Why should he care about asset price inflation when prices and costs remain so well behaved? The answer is that the Fed has singled out home and equity speculation as prosperity's main source of potential destabilization. His truncated logic runs as follows: The pool of available job seekers is dwindling as "labor productivity has not grown fast enough to accommodate the increased demand for labor induced by the exceptional strength in demand for goods and services." This, in turn, has been produced by "an inclination of households and firms to increase their spending on goods and services beyond the gains in their income from production." In other words, consumers have been running down their savings.

How did this happen? The answer is that the "propensity to spend" has been "spurred by the rise in equity and home prices . . ." We have come full circle: Rising stock and home prices have spurred people to go on a spending binge, which, in turn, is straining an already tight labor market. This will lead, eventually, to "significant increases in wages, in excess of productivity growth." No wonder the Fed has been uncomfortable with the proper "weight to place on asset prices."

But if Mr. Greenspan brings the party to an end, in the interest of reducing this "propensity to spend," won't that bring about a depression? Not to worry, he reassures us: "Even if this period of rapid expansion of capital gains comes to an end, *shortly*, there remains a substantial amount in the pipeline to support *outsized* increases in consumption for many months into the future." Adding immediately that "of course, a dramatic contraction in equity prices would greatly reduce this backlog of *extra* spending," he may be signalling that a mere correction may not do the job, and that something a bit more dramatic may be required to reduce the extra or excessive spending (all italics ours).

After dealing, rather ambiguously and inconclusively, with the concept of bubbles ("a large number of analysts have judged the level of equity prices to be excessive," and "bubbles generally are perceptible only after the fact"), he consoles us for what is about to happen: ". . . while bubbles that burst are scarcely benign, the consequences need not be catastrophic for the economy." Neither the bursting of the Japanese bubble a decade ago nor the 1929 Crash led to depressions; rather it was the "ensuing failures of policy," or so he thinks.

Rather belatedly, Mr. Greenspan is here preparing us for

what will happen anyway – or, more likely, for what he is about to bring about: a stock market crash. Hopefully, it will be handled properly, perhaps in the same manner as the Fed dealt with the aftermath of the 1987 crash – providing enough liquidity to forestall widespread systemic failures. He must have had something like that in mind when he added that “certainly, the crash of 1987 left little lasting imprint on the American economy.” A few lines later, he confirms this idea: “Should volatile asset prices [read: collapsing stock prices] cause problems, policy is best positioned to address the consequences when the economy is working from a base of stable product prices.” In other words, if inflation is still benign at the time of the coming crash, the Fed will be able to contain the damage by easing money once again.

Significantly, he ended his testimony with the following words: “It is the job of policy-makers to mitigate *the fallout when it occurs*, and hopefully, ease the transition to the next expansion.” Why would he close his remarks by referring to a fallout, *unless that was a foregone conclusion*? In other words, will he persist in tightening – one quarter at a time – until he eliminates the source of the naughty propensity to spend?

We referred earlier to Mr. Greenspan’s truncated logic. Indeed, he should know better than to characterize asset price inflation as the destabilizing element. Asset price inflation is not an endogenous phenomenon. Rather, it is the result of years of excessively easy money, itself the consequence of a

monetary policy that has lost contact with the true demand for money. Fiat money has been managed by a well-meaning – but misguided nonetheless – team of technocrats, not gratuitously called central bankers. They have fixed the “price” of money much as the former centralized economies fixed the price of shoes or bread – with complete disregard for the laws of economics. Little wonder, then, that they have manufactured too much money.

The numbers bear it out: The growth of the broad monetary aggregates has been accelerating ever since the Mexican crisis, hitting recently the fastest pace since the very early '80s, a time of serious inflation. Our own favorite, M1, after due weight is given to rising money velocity, has been flashing red for well over two years. The Fed’s adjusted monetary base – the one variable totally under its control – has been exploding upward, at 9% year-over-year and at 14% in the most recent two months, all but proving that the price of money has been fixed too low.

It is not just asset price inflation that threatens the stability of the economy. More fundamentally, it is a fiat money system that has, predictably, lost its way. One, two or even three hikes in Fed Funds will do little to remedy the situation, though they will certainly begin to unwind the speculative excesses of the past decade. When it is all over, let us hope we will all concur that money is too important to be left in the hands of central bankers.

CHINA

The renminbi revisited

By Steve H. Hanke

For the Chinese, 1999 is the year of the rabbit, but for economic scribes who focus on the Middle Kingdom, it is turning out to be the year of the renminbi. Indeed, we have devoted two articles to that partially convertible currency since January (see our Jan. 31 and March 28 issues). Those articles concluded that a devaluation of the renminbi was not imminent. Consequently, the other currencies in the region were not threatened by an adjustment in the renminbi’s peg.

The most recent flood of ink about the renminbi began to flow last month, when China lifted its “no-devaluation pledge,” and the official taboo against public debate about a devaluation. Although this change in China’s official exchange-rate posture does not foreshadow an imminent devaluation, it requires us to revisit the renminbi.

Why – for the first time since Zhu Rongji, the premier of China, took office in March 1998 – is an open debate on the merits and demerits of keeping a rigid pegged exchange rate permitted? To answer this question, we need look no further than the deflation bugaboo. Retail prices in China have declined for the past 21 months, falling 3.2% in the first 6 months of 1999, a rate that might understate the true extent of deflation, because China imposes price-control floors. Even though year-over-year real GDP growth was 7.1% in the second quarter of 1999, just a hair above the 7% target, it has been declining since the fourth quarter of 1998 and is relatively low by contemporary Chinese standards.

The combination of deflation and relatively slow growth has caused the international chattering classes to react in knee-jerk fashion. Led by the World Bank’s chief economist, Joseph Stiglitz, the “experts” have told the authorities in Beijing that to accelerate growth, deflation must be licked and that the devaluation of the renminbi might just do the trick. The deflation bugaboo is alive and well.

Before we assess the prospects for a renminbi devaluation, we are obliged to comment on the deflation bugaboo, because it has reached the status of conventional wisdom. Consequently, it has blinded many observers and distorted their judgments about what is going on in China and the future course of the renminbi. They claim that countries experiencing deflation are destined, at best, to stagnate. This chain of reasoning is so short, simple, and oft repeated that it has the quality of a self-evident truth. But, it is not.

History, in fact, shows that deflation and stagnation do not necessarily go together. During the greenback episode in the US, a deflation of 50% took place in the decade and a half after 1865. This decline in prices did not produce stagnation, however. Indeed, the deflation was accompanied by an extraordinary increase in output and real income. Japan also experienced deflationary growth in the 1920s, when prices fell on average by 3.4% per year and real income increased by 2.1% per annum.

Deflation, therefore, is not necessarily a drag on real eco-

conomic growth, which is measured by nominal GDP minus a price index. Indeed, there have been episodes of deflation and robust real economic growth. To start with a clean slate, exorcise the deflation bugaboo, please!

With all the recent talk about a devaluation, we must determine whether there is pressure on the renminbi, pressure that might force a devaluation. For a country with a pegged exchange rate, the balance of payments statistics are the best or even the only means of judging international performance. And the most important balance is the change in official reserves, since it represents the amount the central bank is forced to buy or sell foreign exchange to maintain the pegged exchange rate. China's foreign reserves grew by 5.1% during the past year and are a staggering \$150.7 billion. And were it not for large illegal capital flight, these numbers would be significantly larger. The growth in reserves means that to hold the renminbi peg at 8.28 RMB/\$, the central bank had to buy dollars and sell renminbi. The renminbi has not faced downward pressure during the past year. Indeed, absent the central bank's accumulation of foreign reserves, it would be appreciating.

To determine the origin of the foreign reserve buildup, we have to look at other balances in the balance of payments. And we don't have to look too far to see that both the trade and current account balances are in surplus. During the past 12 months, through June, the trade balance has been positive at \$29.1 billion. And for 1998, the current account surplus was \$28.4 billion. That said, the trade balance has been deteriorating, with imports increasing by 16.6% in the first half of the year and exports falling by 4.6%, resulting in an \$8 billion trade surplus. When analyzing the deterioration in the trade balance, caution is advised, however. The strength in imports is somewhat artificial, because China has cracked down on illegal imports this year, and illegal imports have fallen dramatically. Consequently, illegal imports, which used to show up as a statistical discrepancy in the balance of payments, now appear transparently as imports.

There is no downward pressure on the renminbi. But this is not the end of the story. China made several policy changes in June that merit our attention. All these changes are designed to arrest the deflation, boost nominal GDP, and at the same time, protect the renminbi's peg.

To accomplish these objectives, China embarked on a strategy of monetary easing, with an interest rate cut on June 10. A monetary easing should eventually put downward pressure on the renminbi. A relatively easy monetary policy should also put

downward pressure on the black market for the renminbi, as speculators chase higher yields in assets dominated in foreign currencies and exploit loopholes in China's exchange controls.

China, in its simultaneous pursuit of an independent monetary policy and a pegged renminbi, has anticipated all this. Consequently, it has built a fortress around its foreign exchange control regime by closing the remaining loopholes in the system. On June 3, it ordered foreign banks with renminbi accounts at Chinese banks to close those accounts by June 10. It also said that offshore renminbi could no longer be converted into foreign currencies or remitted to China. This means that the 2% of Chinese international trade (imports plus exports) that was conducted in renminbi will no longer be permitted to be conducted in the Chinese currency. It also means that the renminbi held offshore, which were fully convertible at overseas branches of Chinese banks, will no longer be convertible. And if the closing of these loopholes was not enough, the authorities have begun to crack down on money laundering and illegal capital flight. Starting on Aug. 1, Chinese citizens wishing to take more than \$10,000 cash out of the country will have to apply for a license.

It is clear that the authorities plan to play hardball under the new exchange-control regime, too. On July 30, the State Administration of Foreign Exchange announced that its massive enforcement campaign was bearing fruit. During June, more than 260 people engaged in illegal foreign exchange trading were arrested, more than 50 trading sites were smashed, and large amounts of foreign currency were confiscated. Not surprisingly, the black market RMB/\$ rate has tightened, with the black market renminbi moving to its strongest level this year.

While the Western press has focused on the implications of China's abandonment of its "no devaluation pledge," the 1,100 officially registered Chinese newspapers and over 8,000 magazines have been deafeningly silent about a devaluation. This does not surprise us. The real story is that China has begun to pursue an independent, easy monetary policy, and that it is coupled with a beefed-up fortress around China's exchange control regime, one designed to protect the renminbi's peg at all cost. For now, the Chinese have waved off the foreign "experts." And we end where we started. The devaluation of the renminbi is not imminent and does not pose a threat to other Asian currencies.

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EMERGING MARKETS

Emerging markets, slim pickings

By Steve H. Hanke

As we note in an accompanying article in this issue, even the bulls are getting nervous. Widening yield spreads between US Treasuries and emerging market debt tell part of that story. Consequently, emerging market debt offers slim pickings. What are they?

Turkey is one country that pays handsomely for the risks involved. Since 1994, when the lira last collapsed, Turkey has

been operating in a rather tenuous equilibrium, one with very high inflation and strong growth rates. Indeed, annual inflation (measured by the CPI) has been stuck in a range of 80.4% to 89.1%, and annual real GNP growth has ranged from a low of 3.8% to a high of 8.3%. But an equilibrium it has been, one that has not been disturbed by either the Russian or Brazilian devaluations.

The lira, a key variable in the Turkish story, has been remarkably well behaved, crawling downward on a well-defined path. We, of course, are well aware that these crawling pegs can get into big trouble, as the lira did in 1994. Back then, a huge loss in foreign exchange reserves gave a clear signal that trouble was ahead, and trouble it was. During the past year, however, Turkey's foreign reserves have been stable. At \$23.35 billion, they are only 9.5% below reserves a year ago. And in the July 16-23 reporting period, reserves surged by \$739 million, indicating that the central bank was buying foreign exchange and selling lira to keep the lira's crawl on its downward glide path.

We anticipate that the Turkish equilibrium will be maintained over the next 12 months. We view Turkey in terms of months, not years. Turkey has made good progress on banking and pension reforms, as well as public sector wage negotiations. It has also landed an IMF stamp of approval recently, and with the IMF monitoring program in place, we are confident that there will be more structural reforms. These should prepare the way for inflation eventually to come down.

Looking out five months, and that is as far as we would venture, the January 2000 lira T-bills are yielding about 14% in US dollar terms for an annualized return of about 30%, given the lira's glide path rate of depreciation.

Bulgaria, where I operate as President Stoyanov's economic advisor, is another emerging market worthy of consideration. Bulgaria's currency board system differentiates it from most other emerging markets.

Many critics of currency boards argue that a number of preconditions must be satisfied before a currency board can be introduced. For example, the *Annual Report of the Council of Economic Advisors* (1999) states that "A currency board is unlikely to be successful without the solid fundamentals of adequate reserves, fiscal discipline, and a strong and well managed financial system, in addition to the rule of law (p.290)." What nonsense.

There are no preconditions for the successful establishment of a currency board. That is why all attempts to establish currency boards have been successful. There have been no failures.

Bulgaria provides an excellent example. In 1997, Bulgaria was a Balkan basket case. After defaulting on its foreign debt in 1990, Bulgaria was virtually cut off from international credit. Hyperinflation, which peaked at an annual rate of 2,040% in March 1997, had wiped out the banking system, sent the real economy spiraling downward, and left what private businesses Bulgaria had near bankruptcy. Then, on May 2, 1997, Bulgaria approved a draft currency-

board law, and allowed its currency, the lev, to float until July 1, 1997, when it chose the deutschmark as the reserve currency, fixed the exchange rate at 1,000 lev to the deutschmark, and required that all monetary liabilities of the Bulgarian National Bank be fully backed by deutschmark reserves. But Bulgaria didn't have enough foreign reserves to fully back the lev. The reserves were made available by the International Monetary Fund and the World Bank, however.

After the launch of Bulgaria's currency board, interest rates immediately collapsed and the economy came out of its nosedive. Last year, Bulgaria registered 4% real growth, and today inflation is nonexistent. And Bulgaria's fiscal house is in order. To June 17, tax revenues were 51% of their yearly target, while expenditures were at 41%. Consequently, the fiscal surplus to June 17 was \$136 million. Bulgaria succeeded without any of the so-called preconditions for the establishment of currency boards being met. This occurred because there are no preconditions for the successful establishment of a currency board.

Bulgaria's current account deficit is expected to be \$700 million in 1999. With strong reviews from the IMF and World Bank, official financing is not in jeopardy. In addition, Bulgaria's parliament was one of the first to vote to approve NATO air strikes in Kosovo, and it also refused Russian overflight rights. The Clinton administration reacted immediately with a \$588,000 grant to study the Trans-Balkan pipeline. Official financing is, therefore, totally secure. Add to that larger-than-expected revenues from last month's privatization of Bulgarian Telecommunications (\$510 million) and Neftochim (\$107 million), with an investment obligation of \$500 million, up from the previous \$77 million, and we have an "overfunding" of the current account deficit. This could result in a credit upgrade and/or Brady buybacks.

Even though structural reforms are on the right course, they have been slow in coming. This criticism was fully covered in the *1999 OECD Economic Surveys, Bulgaria*. During my visit to Sofia last month, I raised this issue with President Stoyanov, and suggested that the government form a task force to review structural reforms, with an eye on the possibility of identifying ways to accelerate them. Prime Minister Kostov and the Council of Ministers accepted my recommendation, and Mr. Kostov announced this result on July 23. The government is on course to accelerate structural reforms. Yet another positive for Bulgaria.

All this is good news and makes the Bulgarian yields look pretty juicy, given the risks. Pending an improvement and stabilization in the emerging markets, shorter duration paper is the best bet, even in Bulgaria.

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