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Inflationary pressures growing

The Fed lifted rates by a quarter of a percentage point to 6% and said more action to damp the economy was likely this spring. Stocks and bonds rallied despite the move, as some investors optimistically anticipated the end of such increases. So read the lead capsule of *The Wall Street Journal* of March 22.

It said it all: that the Fed was still bent on a gradualist operation – witness the choice of one-quarter point only; that it leaned on threats and jawboning to cool off a searing economy, saying that more action to damp the economy was underway soon; finally, that investors remained supremely confident that the economy required only minor surgery and that the Fed was an absolutely reliable surgeon. In the accompanying article, our colleague Mark Mullins makes the case that in fact, the Fed has been succeeding in tightening the noose and that it may not be too far from achieving total success, that is, a soft landing, which will restrain growing inflationary pressures.

With all due respect to this well-documented view, we are not so sure. Goods prices are climbing across the board (our commodities diffusion index has reached a new multi-year high), the core PCE deflator for services has been accelerating and has been running at an annualized rate of 3.2% in recent months, with housing only a small part of the story. With respect to services, one can't help but be impressed by the breadth of the phenomenon: entertainment, personal care, personal business, and medical services. Air fares, pushed up by recent fuel increases, are only a tiny part of the overall acceleration of service prices. In short, the breadth of the acceleration tells us that we are not merely witnessing an energy/foods spike – as the media and Wall Street would like us to believe – but an entrenchment of the well-known blight of inflation.

To justify its optimistic outlook, the Fed has waved the flag of the New Economy with its strong spurt in productivity. But this may no longer be sufficient. Productivity growth is highly cyclical, and the Fed's very attempt to slow down the economy will certainly hurt productivity, causing further pressures on costs. The '60s provided a useful reminder that high productivity is not sufficient to restrain labor costs (the inex-

pliable focus of Fed watching). Charts 2 and 3 show a distinct acceleration of hourly labor costs against a background of still high but modestly-slowng productivity growth (within a context, of course, of a slowdown in output).

Investors seem absolutely oblivious to the lurking danger. The leads and lags of monetary policy, in particular the growth of the money aggregates, are highly uncertain: Monetary stimulation on a grand scale, such as we've witnessed over the past five years, may take time to work itself through the system. In the end, however, it does, regardless of new productivity paradigms and the ostensible New Economy.

Serious investors can easily monitor developments on the inflation front. They need only focus their attention on commodity prices, always highly sensitive to growing inflationary pressures. Despite a strong US dollar, the Commodity Research Bureau and the Journal of Commerce Industrial indexes (see Charts 4 and 5) have been advancing relentlessly to new two-year highs, leaving little room for hope of a soft landing.

Contrary to investors' expectations, *the battle against inflation has just begun*. The Fed will need to notch up rates for quite some time. Unfortunately, time will be working

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Contributions by Albert D. Friedberg, Dr. Steve H. Hanke, and Dr. Mark Mullins.

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

against it. For one thing, inflation will become ever more entrenched, affecting expectations and the velocity of money (so that for any given increase in money, inflationary pressures will accelerate). For another, more and more investors are placing their life savings at risk, unaware of the true risks of variable returns (will 100% of households, up from an estimated 55%-60% now, get involved in the stock market?).

Increasingly, the Fed will be stymied from taking the correct tightening measures, in the justified fear that a substantial market decline will have a devastating impact on the real economy. While this outcome can no longer be avoided, the Fed is likely to bury its head in the sand for as long as possible, deferring decisive action until inflationary pressures become so large as to evoke a political backlash.

Chart 1 – Consumer Price Index

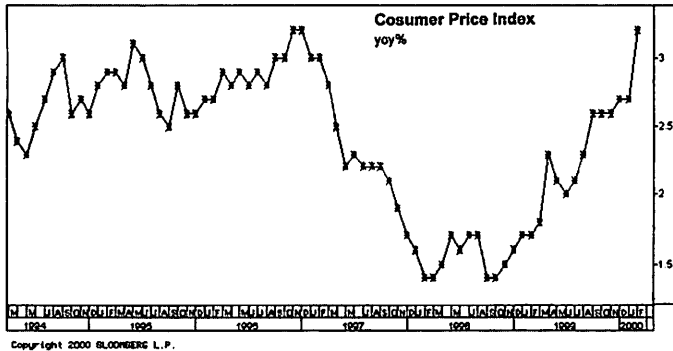


Chart 4 – CRB Index

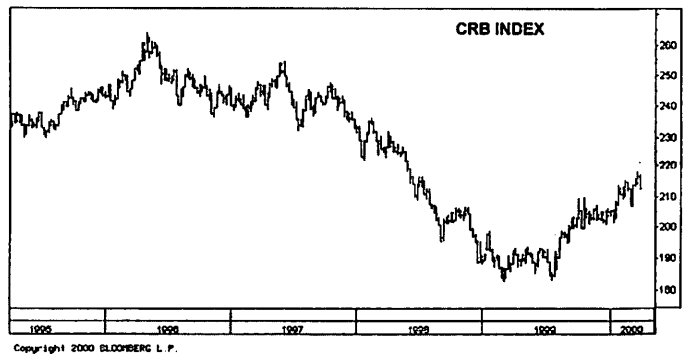


Chart 2

Inflation and labor costs in the 1960s

%oya, nonfarm business

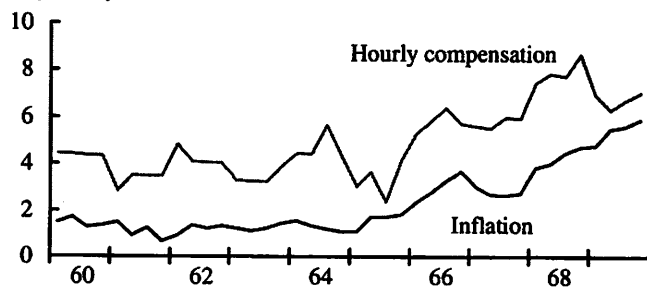


Chart 3

Labor productivity and output in the 1960s

%oya, nonfarm business

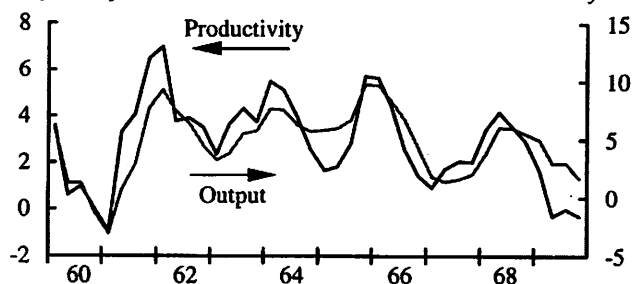


Chart 5 – Journal of Commerce Industrial Prices, Commodity Index

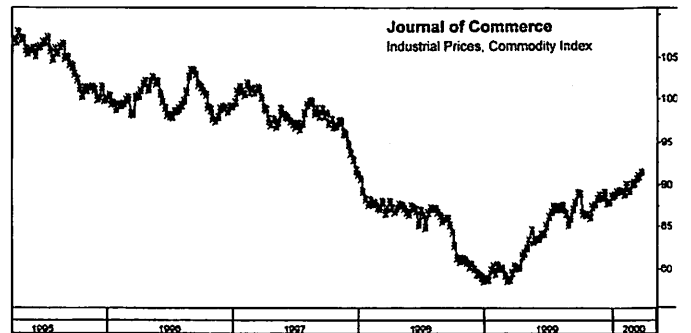
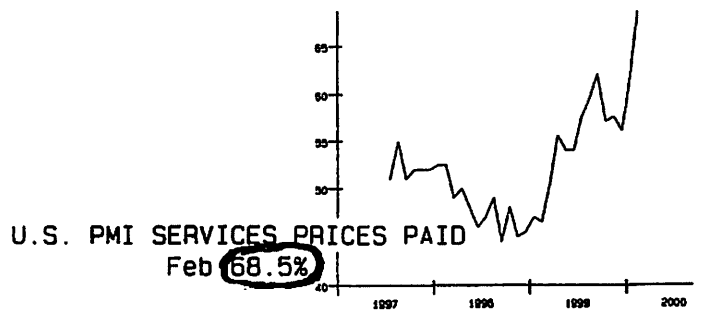


Chart 6 – U.S. PMI Services Prices Paid



ISI Group

Global Data Watch,
J P Morgan

FEDWATCH**Brain waves at the Fed***By Mark Mullins*

The poor old Fed. What is one to do when all of the old models are breaking down?

First, it was the Phillips Curve, the relationship between the jobs market and inflation. The hotter the jobs market, the higher the inflation rate. Unfortunately, this signpost for monetary policy has been spun in no particular direction in recent years as unemployment has tracked progressively lower to 4% and core inflation has stayed in a 2% to 3% range.

The next failure was an unsurprising candidate: money supply. It had been providing little guidance since the heady years from 1979 to 1983 when money targeting was the explicit goal of the Fed. But it has plumbed even greater depths of irrelevance recently, as broad money growth started to accelerate to double-digit rates in 1995 and inflation in goods and services refused to respond.

What did respond to heaps of liquidity creation was the stock market. So, it was Alan Greenspan's pointed warning of "irrational exuberance" in December 1996 that ushered in a newer twist to monetary-policy setting. Market verdict to date: 3,600 points upside on the Nasdaq and 4,600 on the Dow Jones Industrial Average. It seems that targeting stock prices is a tad more difficult than the Fed imagined – and their heart really is not in it anyway.

The latest failure is the link between inflation and excess demand. It used to be that growth rates above 2.5% in the US were seen as potentially inflationary and were to be dealt with severely (or at least with a typical Greenspanian incremental approach of a quarter-point increase in interest rates every second month or so). Alas, the economy has entered its fourth year of 4% growth and just came off a fourth quarter where the number was closer to 7%. So much for capacity constraints – and with additional uncertainty concerning the impact of the Internet on fundamental economic relationships to boot.

So just what is the Fed to do? Proclaim an asset bubble and prick it post haste in the manner of Japan circa 1989? Do nothing and watch inflation take off with a longer-than-usual lag (the back-to-the-sixties approach)? Or wade out into the waters with eyes closed, brandishing a stick and speaking in a loud and confident manner?

It appears that the latter approach is being taken. The Fed is gradually raising credit costs, expressing concern about the valuation of stocks and the dollar, and urging the banking system to tighten credit conditions. They are also

confident that higher interest rate credit-spreads, an inverted yield curve, and high real interest rates will ultimately slow the economy.

The one major problem with this approach is that it is blind in one eye. Owing to what the Fed has described as "greater than usual uncertainties," there is less faith in forecasting tools and more trust placed in day-to-day observations of the economy and markets. This inevitably forces the analysis into a simple construct assessing today's interest rate against today's economic rate of growth. Time lags be damned, strong growth now requires high real interest rates (and higher if it does not slow).

The standard focus is on the Fed Funds rate. Six percent rates for banks and government borrowers, and 8% plus for commercial entities, in a world of 2%-to-3% inflation is fairly tight. In fact, policy has not been this tight in inflation-adjusted terms since 1986.

The Fed also uses more sophisticated monetary or financial conditions indexes, which throw bond yields, currencies, and stock valuations into the mix. On a measure including bonds and the US dollar, policy today has moved as high as the peaks of 1989 or 1994. A broader measure that adds equity valuation leads to a similar conclusion, though at a slightly less onerous degree of monetary tightness.

The clincher in this argument that the Fed has been cumulatively placing pressure on the markets and the economy comes from an examination of the Fed's balance sheet. Imagine that you have a perpetual-motion money machine. At the mere flick of a wrist (or push of the button these days), you can print currency and then purchase goods and services to your heart's delight. Being a responsible citizen, however, and with one eye on the potential for inflation and fiscal irresponsibility, you choose to limit the pace of the print run and buy only government debt securities. This, in essence, is the Fed's balance sheet.

It may come as a surprise to note that the Fed has not only drained off all of the excess liquidity created for potential Y2K problems, but it has also continued to limit its asset growth after this was in hand. In fact, the Fed balance sheet is nearly shrinking. And that is not all. Foreign holdings of US government securities by other central banks are also down in recent weeks. And MZM, an interest-rate-adjusted measure of narrow money supply, is flat in the first quarter of 2000. Thus, thinks the Fed, the squeeze is in, with fairly pre-

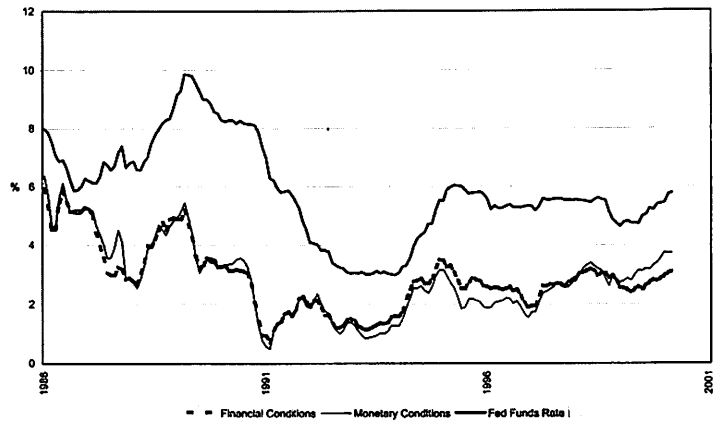
dictable results for financial market prices and the economy. The only real uncertainties pertain to the timing and magnitude of the subsequent reactions.

So the Fed has been building a case against the markets and the economy since last summer (and arguably since 1997, with a small sidestep in 1998 for the Long-Term Capital follies) on the basis of little but a day-by-day assessment of economic and market conditions. We are still not at the point where there is a sense that this policy has grown teeth and is starting to have a real impact. But that day may not be far away, if the typical historical response to monetary tightening is a reliable starting point for analysis.

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Chart 7

Monetary Policy Measures



INTEREST RATES

Interest rates, nominal and real

By Steve Hanke

In the face of good news about the growing US budget surplus, the nominal interest rate on the 30-year benchmark government bond has climbed by about 100 basis points during the past year. This has obviously frustrated Treasury Secretary Lawrence Summers. In consequence, the Treasury Department announced in March that it would buy back part of the national debt. And for the first time in 70 years, the US, with great fanfare, has started this buyback operation.

Ironically, because Treasury bonds are not callable, repurchases of bonds bearing relatively high interest rates will require an extra expenditure of taxpayers' money, because a premium will have to be paid for repurchased bonds that yield more than the current interest rate of about 6%. For example, a bond due in November 2006 carries a coupon interest rate of 14% and a price of \$1,432 per thousand. Hence, a buyback would reduce the budget surplus by \$432 for every \$1,000 of face value of repurchased November 2006 bonds. Never mind. The Treasury has begun its buy operations in a so-called reverse auction, in which it has accepted voluntary offers from investors interested in selling their securities.

All this has set off an enormous amount of press coverage and consequent nonsense about the determination of nominal interest rates. Most commentators, as well as Treasury Secretary Summers, believe that a reduced supply of Treasury securities will raise their price, and consequently, yields will fall. As it turns out, the level of government bond issue, or the lack thereof, and government deficits or surpluses are not important factors determining nominal interest rates.

Just consider the broad experience of Japan in the late 1990s and the US in the early 1980s. In both cases, the fiscal

picture was deteriorating rapidly. During the years since 1992, Japan has engaged in 11 large fiscal stimulus packages, and the budget deficit has exploded. However, nominal interest rates fell from their highs of about 5% in 1994 to a low of 0.7% in the fall of 1998. Subsequently, they have risen to about 1.75%. In the US, nominal rates fell from their highs of about 15% in 1980-81 to 8% in 1986, and this occurred amid cries that the US would face budget deficits as far as the eye could see.

What's going on here? There are two reasons why government finances have little to do with the determination of nominal interest rates. First, even in Japan and the US, where government deficit financing operations have been large in absolute terms, they have amounted to a small share of the world's issuance of interest rate instruments. And second, most of the movement in nominal interest rates is determined by changes in inflation expectations, which in turn operate on expectations about central bank actions that determine short-term nominal rates.

What does all this mean? It means that most of the chatter about the supply of government bonds and its influence on nominal interest rates is balderdash. Stop reading the press accounts about it. It is all confused and confusing.

* * * * *

The nominal interest rate on so-called risk-free government bonds can be decomposed into two parts: the inflation rate and the real rate. In countries that issue indexed bonds – such as the US, where Treasury Inflation Protection Securities (TIPS) are issued – the real rate of interest can be observed directly. For example, the real rate (yield) on 10-year TIPS is now 4.19%, and 4.11% for 30-year TIPS.

Because the US Treasury also issues nominal bonds, we can calculate an implied inflation forecast directly by subtracting the real yield on TIPS from the yield on nominal bonds with the same duration. With 10-year nominal bonds yielding 6.29% and 30-year nominal bonds yielding 6.08%, the market's implied inflation forecast currently is 2.1% for the next 10 years and 1.97% for the next 30 years.

This means that if the actual average inflation rate exceeds about 2% over the next 30 years, TIPS will outperform nominal bonds. We believe that inflation will average more than 2%. In consequence, on a relative value basis, we believe TIPS, not nominal bonds, are the place to be.

Why are the markets anticipating that average inflation rates will remain low by historical standards? Market participants tend to base their inflation forecasts on the average rates over the past three years, and not surprisingly, that average is 2.03%. That is almost exactly what the market's implied inflation forecast is.

Our inflation expectations are higher than those implied by the markets, because we think we understand the workings of central banks operating under a fiat money standard. History has shown that this type of setup will produce inflation rates over the next 10 to 30 years that exceed 2.0%. Needless to say, the historical record supports our expectations.

The most recent data also support that position. Indeed, CPI inflation on a year-over-year basis in the US has risen dramatically. It was 1.6% in February 1999 and is currently about 3.2%, suggesting that market participants will begin to revise their inflation expectations upward in the near future.

That TIPS are a relative value does not prove that they will be a profitable investment, however. For TIPS to be a profitable investment, real yields will have to decline from their current levels of slightly more than 4.0%.

Will that become a reality? We believe it will. If inflation

expectations moved exactly in line with changes in inflation, real yields would remain constant at all times. The historical record shows that real yields swing up and down, however. This occurs because inflation expectations are based on the last three years of inflation experience. In consequence, inflation expectations lag changes in inflation.

When inflation rises and inflation expectations lag, real yields fall and vice versa. This empirical relationship explains why real yields have been relatively high in the American deflationary environment of the past few years. It also explains why real yields will fall when inflation picks up.

It turns out that there is a sound theoretical justification for the empirical relationship in which real yields fall when inflation accelerates. It was developed in the early 1960s by none other than Professor Robert Mundell, the current Nobel laureate in economics.

The crux of Professor Mundell's theory is that the real rate declines when unanticipated inflation accelerates, because inflation reduces real money balances. In other words, money assets depreciate in real terms. In consequence, real wealth declines, and this stimulates increased savings as people attempt to bring the value of their real money balances back up to desired levels. This, in turn, brings downward pressure on the real rate.

We believe that in an environment of increasing inflation, TIPS will prove to be a relative value. In addition, they will provide investors with sizable capital gains, because real yields will decline. Although TIPS might be a boring investment, they will prove to be a *very profitable*, boring investment.

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CREDIT WATCH

Moral hazard, again

In a House banking subcommittee hearing on a bill put forward by its chairman, Richard Baker, Treasury undersecretary for domestic finance, highlighted a Government Sponsored Enterprises (GSE) horror story. These privately-owned but federally-chartered companies, created by Congress to help overcome barriers to the flow of credit into certain segments of the economy (principally housing), have expanded their portfolios over the past decade beyond anyone's wildest imagining.

Here are some astounding facts:

- Under the Congressional mandate to provide liquidity and ongoing assistance to the secondary mortgage market, the GSEs – principally Fannie Mae and Freddie Mac – now hold \$850 billion of mortgages and mortgage-backed securities and \$80 billion in non-mortgage securities, while the Federal Home Loan Bank provides advances to banks and thrifts and directs approximately \$170 billion in investments.
- The intermediary function of these GSEs is facilitated by their quasi-fiscal status. While their securities neither enjoy government guarantees nor receive funds from the federal government, they are regarded in the marketplace as good as the government because of a number of benefits that are available to them. As an example, among debt securities issued by private companies, GSE debt securities are exempt from the normal investment limits imposed on commercial banks. As a result, GSE debt rep-

resented, as of mid-1999, just under 4% of total bank assets and over one third of bank capital. Banks held 75% more in GSE debt than Treasury securities. Their quasi-fiscal status allows them to borrow money at lower rates than other financial institutions: 30 basis points, on average, below AAA-rated banking and financial firms (despite their presumed AA-rating) and 18 basis points below 3-month LIBOR, which represents the rate at which banks generally obtain inter-bank funding.

- Their near-impregnable status allows them to operate with far more leverage than any other financial institution: Fannie Mae and Freddie Mac have roughly \$32 of debt for each dollar of capital, compared with \$11.50, \$12.50, and \$25 of debt for each dollar of capital for large banks, thrifts and the five largest securities firm.

Little wonder that their portfolios exploded at the most critical instances of near-credit-collapses in the past three years! There is no reason to believe that their activity was guided by the Treasury or the Fed in an attempt to restore stability to the market in the aftermath of the Russian default or the near-collapse of LTCM, as some observers have suggested. It was simply a case of profit-maximization. In effect, their ability to arbitrage with impunity, borrow at Treasury rates and lend at widening spreads, when everyone else's credit fell under suspicion, prompted their growing involvement at just such critical moments.

The Baker bill, H.R. 3703, is a valiant, but ineffectual, attempt to rein in these financial monsters by promoting more market discipline, increasing transparency, and promoting market competition. Perhaps the most important reform, exposure limits, is only highlighted but not includ-

ed in the bill. As pointed out above, GSE obligations are exempt from bank's investment-securities limits. The undersecretary asks that Congress should *consider* the best way to repeal such exemptions, allowing for a sufficient transition period to prevent any market disruption.

The GSEs have become too big to fail. The fact that they own or guarantee roughly 63% of all outstanding conforming, conventional mortgages and thus are the dominant institutions in the secondary market, and the fact that their obligations represent as much as 33% of bank capital, make them de facto fiscal institutions.

Corollaries:

- 1) The Baker bill threw a scare into the GSE debt market. You can bet, however, that their spreads against Treasuries will narrow once again.
- 2) As we move into the deteriorating phase of the credit cycle, GSEs will find many other ways to ply their trade. With or without official guidance, they will wade into the waters of the high-yield market, becoming the government-preferred, off-budget bailout instrument.
- 3) More banks will learn that Big is Safe and that mergers are beautiful.
- 4) The next time credit defaults hit Fannie Mae and Freddie Mac, remember what happened to Chrysler and Lockheed, and then call your broker and place an order to buy their shares.

Chart 8 - U.S. GSE Loans

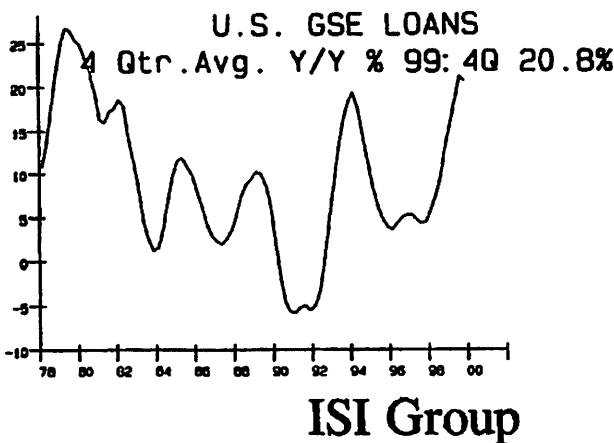
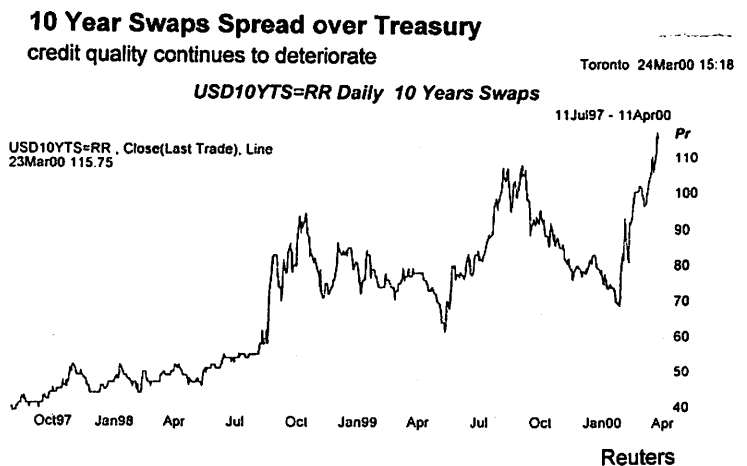


Chart 9 - 10 Year Swaps Spread over Treasury



JAPAN**The great growth debate***By Steve H. Hanke*

Last month, Japan was humiliated by Moody's. That's when the rating agency downgraded Japan's government debt. This infuriated the Japanese and led Harukiko Kuroda, Vice-Minister of Finance for International Affairs, to proclaim angrily that the downgrade "had no logic." The downgrade also set off a great debate about Japan's prospects for growth.

The growth debate was further fueled earlier this month, when the gloomy fourth-quarter 1999 economic statistics were released. Deflation continued in the fourth quarter, with the GDP deflator down 1.5% versus the fourth quarter of 1998. And Japan's economy shrank by 5.5% on a seasonally-adjusted annualized basis in the fourth quarter of 1999. This followed a 3.9% drop in the third quarter.

For 1999 overall, real GDP growth in 1999 was 0.3%. Not bad, considering 1998's slump of -2.5%. Never mind. With two negative quarters, Japan is technically in a recession and a long way from the boom many anticipated. Indeed, the short-lived recovery is over. No wonder Moody's called for a debt downgrade.

But that's not the end of the statistical story. Both domestic demand and net exports subtracted from GDP in the last quarter of 1999. Domestic demand led the way downward, with private consumption off by 6.2%, residential investment off by 21.3%, government consumption off by 0.4%, and government investment off by 19.9% (all in seasonally-adjusted annualized rates).

* * * * *

The gloom that has engulfed Japan since 1992 can be laid squarely at the feet of Japan's misguided mix of monetary and fiscal policies.

On the one hand, monetary policy has been tight, with the Bank of Japan targeting interest rates at levels that are too "high," given the weak demand for credit in Japan. Consequently, the BOJ has been forced to drain reserves regularly from the banking system, resulting in weak monetary growth. On the other hand, fiscal policy has been lax. Indeed, there have been 11 major fiscal stimulus packages since 1992. In all, they have amounted to a whopping ¥209.86 trillion, forcing the gross government debt to the highest levels of any OECD country, about 125% of GDP. And according to Moody's, this percentage will climb to 140% in 2000.

Why hasn't all this fiscal laxity pulled the economy out of its slump? After all, the textbooks tell us that is what is supposed to occur.

The effectiveness of fiscal stimulation seems to hinge on the mysterious factor "confidence," something Keynes himself laid great stress on. When fiscal deficits are relatively large and the state of confidence is low, as they are in Japan, a fiscal stimulus fails to prime the pump, because it isn't credible. Entrepreneurs and consumers know that an ever-looser fiscal stance today will bring higher taxes tomorrow. Consequently, they respond to a fiscal stimulus by making provisions so that they can eventually pay the taxman. The stimulus goes for naught, or worse.

What's needed to pull Japan out of its deflationary slump is a set of credible macroeconomic policies. Tighter on the fiscal front, please. Indeed, Japan should close its huge fiscal deficit by reducing government outlays. The Japanese government has already wasted enough money on unwanted public works. Indeed, the waste has gotten so bad that Tokushima, a small southern city, has revolted by voting a resounding "no" in a referendum on the central government's plans to give the region a new \$1 billion dam.

But how can a fiscal consolidation stimulate an economy? It can do so if the Keynesian fiscal multipliers are negative, not positive. Contrary to the textbooks, multipliers are negative when fiscal deficits are large and confidence is low. For example, the experience of the 1983-86 Danish and 1987-89 Irish stabilization programs shows that fiscal consolidation and tightening stimulated economic growth and brought down unemployment. The fiscal multipliers were negative. Even the IMF, in the *World Economic Outlook* of May 1995 makes the case for fiscal tightening in cases like Japan's, where fiscal deficits are high, confidence is low, and fiscal multipliers are negative.

And what about monetary policy? To stabilize the economy, broad money should be growing at about an 8% annual rate. Now it's growing at a 2.1% annual rate. The BOJ's problem is that it has religiously pursued a policy of interest rate targeting focused on the overnight call rate (similar to the Federal funds rate). And with a weak demand for credit, the target rate has been too high to accommodate money growth.

Will the BOJ stop targeting the overnight rate? In an important, but confused, article in the March 6 edition of *The Wall Street Journal*, Kazuo Ueda, a member of the BOJ's policy board said, "no way." And he reflects the

overwhelming opinion of the majority of the BOJ's policy board members. Incidentally, Mr. Ueda is confused because he believes that the BOJ can control a price (interest rate) and a quantity (money supply) simultaneously. He obviously needs a refresher course in Economics 101. That would teach him that you can set a price or a quantity, but not both at the same time.

* * * * *

This fatal monetary-fiscal policy mix means that no rebound is in the cards for Japan. Indeed, if we look at all the periods in which countries had monetary and fiscal policies that went on opposite directions, we find that

monetary policies uniformly dominated fiscal policies.

What about the yen? We are going to have more of what Ronald McKinnon and Kenichi Ohno dubbed – in their 1997 book *Dollar-Yen* – the syndrome of an ever-strengthening yen. To trade the long side of the yen can be dangerous, however. Foreign exchange rate policy is set by the Ministry of Finance, not the BOJ. No wonder “Mr. Yen,” Eisuka Sakakibara, knew what the short-run course of the yen would be. After all, he was the man at the MOF who gave the BOJ its intervention orders.

Nothing will change the monetary-fiscal policy mess in Japan until the next major crisis erupts! If you are tempted by Japan, there is a good chance that you will get your fingers burned.

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