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Commodity Comments

September 23, 1975

On COTTON-BULLS and GOLD-WATCHERS

Ever since May 1974 (see Gold: Past & Future - copy available on request) we have been warning of gold's overvaluation. At the time, we arrived 'at $130-140/oz. level as a realistic commodity level' for gold and concluded that we foresaw 'a substantial downward correction in gold prices and consolidation period (defined by a refusal of prices to break into new high ground) lasting as much as 1-2½ years.' The $180 peak of early 1974 was broken late that year with London gold reaching an all-time high of $197.50 but: a) the breakout was accompanied by hysterical waves of buying in anticipation of U.S. citizen's right to buy and b) the futures market, as represented by the January '75 gold at Winnipeg, peaked in early 1974 at 203.00 and did not get over $200.00 in the closing days of December 1974. The breakout into new high ground was not more than the culmination of an ecstasic love affair with the yellow metal that fed on cheap greenbacks (vis a vis continental currencies) and overlooked the cost of sustaining the ongoing affair (carrying charges). From that point on it was mostly downhill.

Following are some excerpts of our comments since the turn of the year: 'Except for brief and intervening rallies, gold has become a sale rather than a hold and would suggest moving to the sidelines...' (price $175/oz-January 6 '75). A brief stint with the short side was unfortunately stopped out at 187 (basis July '75) as per comments of February 5, 1975 and March 10, 1975. On April 8th we gained new courage and stated 'gold prices are slowly eroding as inflationary expectations cool off and the U.S. dollar recovers. We prefer the short side, with stops at 180 basis the London fix looking for an eventual drop to $145/oz.' Finally, on August 25th, with gold trading at 163, we stated that 'relative to other commodity prices, gold remains overvalued...'. By September 23, history was being made as gold failed to hold its much vaunted July 1974 support level of $129/oz and was fixed at $128.75/oz.

Where do we go from here? Is gold cheap? It is naturally fashionable to join the growing chorus of gold bears but some cold statistics are still telling us that, with sizeable intervening rallies, gold may yet see lower levels. Let us see. One. A 50% retracement of its 1971-1974 bull market (a legitimate bull market occurence) would place gold at $116.25; a 2/3 correction (still legitimate-courtesy of Charles Dow) would imply an awful level of $88.50. Two. The last remaining long term uptrend, connecting the various 1971-1972 lows reads 110.00 for early October 1975. Three. The German-Italian collateralized loan agreement assumed a $120 price (will Rome get a margin call?), possibly a value judgement on the part of the German Bundesbank as to the ultimate worth of the yellow metal. Four. Looking back to a period when gold as a monetary asset, enjoyed international equilibrium (i.e. it was slightly overvalued, enough to swell official reserves) one must settle with the pre-W.W.I. price of $20.67/oz; nineteen fourteen marked the apex of the international gold standard. Since that time, wholesale prices in the U.S. have risen approximately 4.7 times as measured by the U.S. Bureau of Labor Statistics-a fair approximation of the commodity inflation we have experienced over the last 60 years. Applying this multiple to our 'equilibrium' price of 20.67 we arrive at $97.15. Bear in mind that this $97.15 is based on an already overvalued price. All in all an ultimate bottom in the $88-$120 area seems in the cards.

As sellers (and potential sellers) we can list: the LDC, who will be running a ruinous $35 billion deficit for 1976, Portugal (with a hoard estimated at $4.5 billion), U.K. ($1-2 billion), Italy, Russia (although most of their selling has already been accomplished), South Africa (who's already hurting as evidenced by the 17.9% devaluation) and the thousands of members of the public who gullibly bought an eternal 'inflation hedge' at between $160-$200/oz. As willing and able buyers (and potential buyers) we can find Germany, France, Switzerland, Saudi Arabia, Kuwait and the thousands of value conscious investors who know quite well that the immense budgetary deficits of the industralized and less industralized world will have to be monetized over the next 3 years if a significant economic recovery is to take place. Time and patience will return gold to well financed hands, much before the coming Bull Market.

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Since commodities, as a whole, are in neither short nor abundant supply, one may find a great deal of merit in pricing commodities on an historical basis, adjusting for the 50% loss of purchasing power that has taken place since mid 1967. The BLS wholesale Spot Commodity Price Index has roughly doubled since 1967 (1967 = 100) standing today at 210. Following is a comparative list of commodity prices which should be used merely as a guide (and not a trading recomendation) to levels of under or over valuation:

COMMODITY	1967 APPROXIMATE AVERAGE PRICE	CURRENT PRICE	PERCENTAGE OF 1967 PRICE	NEUTRAL	(1) OVER VALUED	(2) UNDER VALUED	
BROILERS	24.15	43.10	1.7137			*	H. 46.50
CATTLE	26.00	48.67	1.8719	*			
COCOA	26.00	55.75	2.1422	*			
COFFEE	37.50	83.70	2.232		*		L 167
COPPER	38.00	56.50	1.4868			*	H. 77.50
CORN	1.35	3.012	2.2311		*		L 180
COTTON	27.00	54.35	2.0129	*			
LIVE HOGS	20.00	62.75	3.1375		*		L 30
LUMBER	85.00	117.00	1.3764			*	H 229
ORANGE JUICE	37.50	63.05	1.6813			*	H 124
PLATINUM	160.00	150.80	0.9425			*	H 185
PORK BELLIES	35.00	99.37	2.8391		*		L 46
POTATOES	2.25	7.72	3.4311		*		L 4.60
SILVER	155.00	441.50	2.8483		*		L 380
SOYBEAN MEAL	80.85	142.00	1.7563			*	H 310
SOYBEAN OIL	9.50	22.53	2.3715		*		L 18.50
SOYBEAN	2.69	5.695	2.1171	*			
SUGAR	2.50	14.90	5.96		*		L 7.90
WHEAT	1.60	4.255	2.6593		*		L 3.15

(1) More than 10% above the 2.0 parity.
(2) More than 10% below the 2.0 parity.

Relatively undervalued commodities include Broilers, Copper, Lumber, Orange Juice, Platinum and Soybean Meal. Grossly overvalued are Hogs, Pork Bellies, Potatoes, Silver, Sugar and Wheat. This analysis does not indicate how extreme the degree of under or over valuation is likely to get before a reaction sets in nor the timing of such an adjustment. It does, however, help in formulating a trading strategy that will avoid excessive risk.

Technical Comments

Cocoa	December '75	55.75
	March '76	52.00

In early September, Gill and Duffus cut its forecast of this season's cocoa surplus to 82,000 long tons from the 106,000 tons it predicted in its June report. It further pointed out that there is still no great quantity of 1974-75 crop available in consuming countries. This situation tends to put a large premium on the nearby month (Sept. Dec. switches in both New York and London have been fluctuating at between 5 & 8¢ premium the nearby).

The Ivory Coast cocoa bean crop is now seen considerably lower than 232,000 tons while Ghana's main crop may not be in excess of 380,000 tons, further undercutting the 82,000 tons surplus. It should be noted that end season supplies are estimated at less than 3.1 months' supply, an extremely low level by post-war standards. Offsetting a weak worldwide economic recovery is the descent of sugar prices, now at 15¢/lb raw, a major cost factor in the manufacture of confectionery. Barring a very serious relapse of recession-depression, cocoa prices, one year from now, should sell substantially higher.

In our previous letter we suggested lightening up on a rally to 55-57.00, an opportunity presented to us in mid-month when December '75 traded at 56.00 before correcting to 52.00. The market has a very firm undertone and we now prefer to remain fully committed to the long side, looking for a test of the November '74 highs of 66.5¢/lb. Raise stops to 50¢/lb basis December '75 on close only.

Coffee	September '75	84.70
	March '76	83.18
	London (Robustas) November '75	£740
	March '76	£746

Our remaining long positions in London Robustas were stopped at £750 basis November (as per last Commodity Comments) and we now prefer moving to the sidelines.

Copper	December '75	57.50
	3 mos London Wirebars	£610

Copper prices eased substantially over the past few weeks in sympathy with the sharp sell-off in precious metals. In recent days, however, the market has been taking in stride the decline in gold and silver and the huge increase in LME stocks, thus pointing to the possibility of an early resumption of the uptrend.

Industry (fabricators) stocks in the U.S. are at the equivalent of a 3 months supply at current rates of consumption, while outside the U.S.A. they stand at 4 months. Industry sources feel that a) consumers have shifted the burden of carrying stocks to the producers, usually a well-heeled group and b) customer copper inventories are very near 'rock bottom levels'.

We will still stand to the prediction made last month that within 60 days (end of October) the world will wake up to a 'copper shortage'. The initial move will restore copper prices to their 'parity value' (see above table) of 75¢-85¢/lb. and ultimately the winds of inflation will lift it to new all-time highs.

Long positions were stopped at 58.00 basis December '75 (as per July 21 Comments) but should now be restored and left open with no stops.

Cotton	October 1975	54.35
	December 1975	55.58

Phase II of the major advance has begun. A moderately constructive production report issued by the USDA (9.3 million bales) had little effect on the market as prices had already anticipated a decrease in the order of 100-200,000 bales. We feel the report will have to be revised downwards by a substantial margin to allow for heavy insect damage and very poor harvest weather in good parts of Texas and Mississippi.

Good trade demand continues in evidence while our open interest analysis does not reveal any serious deterioration, as yet.

We advise maintaining long positions looking to December '75 to reach a minimum 75¢/lb by year end. Protective stops should be raised to 51.40 basis December '75 on close only.

Livestock	November '75 Broilers	43.10
	October '75 Hogs	62.75

Our long hog position is now showing an impressive 12¢ profit since first recommended and, naturally, these high historical prices are giving us a certain degree of apprehension. It is no longer a question of whether the hog cycle will turn but when and the end of this year is a likely possibility. Retain October '75 Hogs longs risking a close below 59.25; should the stop not be executed, roll over into December '75.

November '75 Broilers were recommended last month as an undervalued meat play. Recent consolidation around the 44.00 area does not look toppy and we expect prices to reach the upper 40's in short order. Raise protective stops to 42.00, close only.

Orange Juice	January '76	64.75

An unusual buildup in the open interest may be flagging a note of caution.

We prefer remaining with the uptrend considering the present level of under-valuation, the steady and orderly pattern of advance and the upcoming danger-ridden frost season.

Precious Metals	September '75 Silver	441.30
	October '75 Platinum	150.80
	December '75 Gold	131.40

Heavy turnover and a huge buildup in the open commitment may indicate that, aside from usual end season tax considerations, distribution may still be taking place in Silver. Last month we suggested re-entering Silver from the long side at the 4.80-4.88 level basis September '75 with protective stops at 4.75 on close only. We added that this 'stop should be watched closely as open interest figures are revealing a certain amount of distribution in the 500-530 area'. Distribution it was and it will require a much greater amount of quiet base-building before a sustained advance can be carried through.

Short positions may be established at these levels with protective stops at 4.75 basis December '75,close only.

Long platinum positions should have been stopped at 167.00 basis October '75 (as per last month's Comments) and we now await an opportunity to re-enter market from long side. This opportunity may present itself around mid-October '75; if at that time prices are lower than 145 basis January '76, buy with confidence.

Rubber	October/December '75	34.55 p./kilo
	January/March '76	35.70 p./kilo

In the last few days, sterling weakness has been the market's main support. Recent statistics are of a routine nature as the market is quiet awaiting a pick up in U.S. demand.

The remaining long positions in January/March '76 Rubber were stopped at 37.00 (as per last month's Comments) and we now await for further basing action before we re-enter market.

Sugar	October '75	14.92
	March '76	14.25

A look at our parity table will convince the most ardent bull that Sugar, at these levels, is still not historically cheap.

Aside from purely historical considerations, Sugar is moving from short supply to surplus. Total world sugar production in 1975/76 should easily exceed 85 MM tons despite poor weather in Europe and the U.S.S.R., where totals will run 4-5 MM tons over last year. Small decline in Brazil and Argentina will be more than offset by increased U.S. Cane and Beet production. On the demand side, world consumption should contract to a maximum of 75-77 MM tons leaving a net surplus for the 1975-76 season of 5-7 MM tons. When added to the 1974-75 carryover of 15.5 MM tons, next season's carry-over should show a more than adequate 20.5-22.5 MM tons level of stocks. Our conclusion is that sugar prices will return to a far more realistic level-perhaps as low as 6-8¢/lb.

Aggressive short positions should be taken in the March-July options, placing protective stops 200 points higher.

Wood Complex	November '75 Plywood	116.90

Fears of disintermediation and the disappointing news of a 5% drop in new housing permits lead wood futures to lower levels than prevailing cash quotes. The latter are holding up fairly well as a result of the nearly complete shutdown of the forest product industry in B.C. The outlook for a prompt settlement there remain, at best, hazy.

Fears of disintermediation as a result of heavy Treasury borrowing needs for the balance of the year, will turn out unfounded, in our view. In the first place, monetary policy remains slightly restrictive and, this has the effect of lowering inflationary expectations in the long end of the money market. The continued sluggishness in private credit demand coupled with a fair inflation performance (witness the small.2% increase in CPI last month) augurs well for a drop in long term interest rates over the next 2 or 3 months. Secondly, Administration officials, particularly A. Greenspan, are well aware of the potential insolvency of most Savings Banks and Savings and Loans institutions in the U.S. and will take all the necessary measures to see that their liquidity ratios do not get impaired even while mortgage funds are being generously provided.

An analysis of the housing starts report issued last week reveals that the basic weakness in present construction trends lies in the multi-family section where permits declined by 43,000 units to a 219,000 rate. A recent survey by the Advanced Mortgage Corporation shows that the number of apartments authorized during the first half of 1975 was 70-90% below the year earlier period in cities such as Atlanta, Denver, Dallas, Fort Worth,Philadelphia, Boston, Miami, Phoenix,San Diego and Minneapolis-St. Paul. This decline is clearly not sustainable as rental fees have begun to rise, indicating that a tight apartment market may develop early next year; at that point, mortgage money will flow to this area.

The wait may be longer than we originally anticipated but the end result will still be the attainment of the $200 mark for Wood products.

Zinc 3 mos. £362

Liquidate long positions first established at £325 basis 3 mos and move to the sidelines.

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Commodity Futures

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