FRIEDBERG'S

COMMODITY & CURRENCY COMMENTS

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The US dollar: has it really gone haywire?

Before you get nervous, we'll reassure you that the answer is a resounding no. But no less a luminary than Dr. Paul Krugman, an economist at the Massachusetts Institute of Technology, has openly questioned whether the market has gone insane (in an article, "Hot money," which appeared in *The Wall Street Journal*, May 18). The bugaboo of bubble theories (irrational and lately rational(?!) ones) and sustainability paths has reappeared over the past few months as the US dollar refused to roll over and vindicate Dr. Martin Feldstein *et al*'s prediction of 100 ¥/$.

The answer to the puzzle, as we have repeatedly discussed over the previous two years, is relatively simple. Let's review the argument.

The US trade deficit (and its concurrent current account deficit) that began appearing in the early '80s and peaked sometime in late '87/early '88 was *not* the result of an overvalued dollar, but the trade deficit was the counterpart of a very strong inflow of private, *voluntary* we stress, capital. Balance of payments accounting does not permit running a surplus on capital and a surplus on trade at the same time; in fact one will always offset the other.

At times, we observe nations running current account deficits, causing some form of official financing (a depletion of international reserves) and/or a sharp rise in central bank interest rates. In this particular case, causation is moving from the trade front to the capital front. Typically, this is a late development in the cycle, when confidence in the country's ability to attract more private (and voluntary) capital has been severely damaged.

More often than not, in the early stages of a trade deficit cycle, confidence has been gained (or regained), and investors flock to the country's money and capital markets. This flow forces an offsetting trade movement via high domestic inflation and/or a higher exchange rate. All perfectly natural. It is what happened in the US from 1980 to the present (except for a brief, government-manipulated interlude in 1987).

If left unperturbed, foreign capital inflows would have raised the forex value of the dollar to the point of making the US an unfavorable place to invest *vis à vis* Europe and Japan. The resulting slowdown of capital inflows would have required rising domestic interest rates to substitute the withdrawal of foreign savings; the US economy would have slowed down (as it began to do in 1985), and automatically the trade deficit would have narrowed. *Instead*, the US economy was stimulated further, first by the artfully-conducted (verbal-plus) devaluation of the dollar, and second by an unusually fast monetary expansion. Logically, the trade deficit did not improve.

Sometime in 1986-87, the economies of EEC and Japan began to pick up steam, and differential rates of growth *vis à vis* the US narrowed sharply. The US trade deficit responded by narrowing somewhat, especially given the fact that capital inflows slowed down substantially (as a result of the verbal guerrilla war being waged by the G7 central banks); at one point official financing became the only counterpart to the trade deficit (early 1987).

The stabilization of the trade deficit to around $10-$12 billion monthly (we pointed out in "The dollar rules again", August 1988) meant that it no longer was relevant. In terms of GNP, it began to fall. In the mind of traders, it no longer mattered. What is more, traders, an uneducated but quick-to-learn bunch of capitalists, began to realize that 1) trade deficits are not all that bad; 2) have little to do with the particular level of the dollar; and 3) have been remarkably easy to finance (despite dire warnings to the contrary). Not only do foreign portfolios not show any signs of saturation but they do not seem to have enough.

In this issue

On a more sophisticated level, one must argue (as we have repeatedly done for a number of years) that the *real value* of a currency cannot be manipulated by central banks. Fiscal policies, especially tax policies, politics, and terms of trade are a great deal more important than monetary policy in affecting long-run real values, such as exchange rates. In these respects, the US economy continues to look attractive to foreign investors (especially now that President Bush has reaffirmed Reagan's policies of no new taxes), and the real value of the dollar must, inevitably, reflect this confidence via continuous capital inflows.

Chart 1 depicts the US dollar *real* effective exchange rate. In our opinion, the 1985-87 decline was totally artificial, and therefore the dollar is likely to rise considerably (short of a US recession — not an imminent probability) to make up lost ground. Since real variables are arrived at after adjustments for inflation, and since US inflation is unlikely to exceed by a substantial margin the EEC's or Japan's inflation rate (given their disparate monetary policies, tight in the US, easy in Japan and West Germany), we are led to conclude that the US nominal rate of exchange will continue to appreciate.

How far? *Perhaps* a good guideline is the Bretton-Woods parity, the period prior to the breakdown of the international monetary system and the shocking experiment with floating fiat money. Chart 1 points to an index level of 115, implying an approximate *real* rise of 25% from present levels. Clearly, the magnitude of the advance is not as certain as the advance itself.

What *is* certain is that 1) Martin Feldstein, the MIT gang, and the Institute for International Economics will continue to talk the dollar down, advancing nonsensical theories; 2) central banks of the G-7 will fight "like dogs" quoting (Mexico's former President Lopez Portillo as he resisted pressure on the eve of a massive devaluation) to rein in the dollar in the name of the long-term health of the US and the world economy; and 3) short of imposing a ferocious deflationary monetary squeeze on their economies, these central banks will run out of dollars before traders-of-the-world run out of unwanted Deutsche marks, pounds, and yen.

Of course, the US may cooperate by lowering domestic interest rates and closing in the still-substantial gap in its favor. Still, the probable reacceleration of US economic activity is unlikely to give the Fed too much room to ease. Therefore, most of the adjustment will need to be taken by foreign central banks.

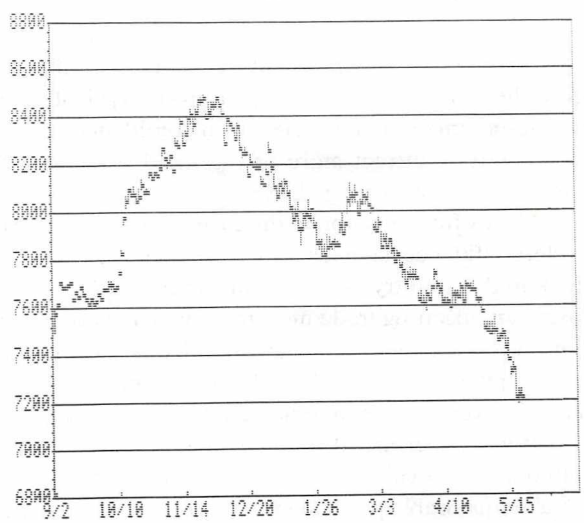
While continuously bullish on the dollar since August 1988, we have traded it on the assumption that the Louvre Accord had "semi-fixed" the dollar between DM1.70-1.92 and ¥119-137. Heavy intervention *somewhere* at the upper end of the range would make for uninspiring trades. A fortnight ago, we covered short currency positions with the yen just under 135.00 and the DM under 192, expecting heavy central bank intervention. The intervention did not materialize until the dollar breached higher levels. By then, a better-than-expected US trade figure and the Bundesbank's refusal to raise interest rates made a two-day $5-billion intervention effort quite ineffectual.

The US dollar's path of least resistance is upwards. And the market has not gone haywire.

STRATEGY: *We have reentered the long side of the US dollar as per the flash update of May 19 (see Hotline Update). The G-7 will not give up easily; intervention packages will become increasingly tougher — some of them accompanied by synchronized interest-rate moves. We are* keen *to add to the long side of the US dollar (shorting* preferably *the Japanese yen) on reactions* after *these packages of measures are announced. Only* then *will we indicate protective stop levels.*

Chart 1

Chart 2
JAPANESE YEN JUNE '89



THE ECONOMY

A note on supply-side spreads

In September, we flashed a yellow light on the economy. Since then, we have retained that caution signal because our supply-side spreads were narrowing and the rate of growth in monetary aggregates was falling.

As we point out in "The Free Reserve Fallacy," the monetary aggregates indicate that the Fed remains relatively tight. Hence, the monetary side of the economy warrants a retention of our yellow light.

Turning to the real side of the economy and our supply-side spreads, we are now receiving mixed signals (see Chart 4). The economy-wide spreads continue to show weakness and have come down to almost zero, indicating that the non-farm business sector cannot be counted on to contribute to economic growth in the near term. However, the manufacturing spreads remain healthy. Indeed, they actually registered an up tick in the first quarter of 1989. Hence, the manufacturing sector might contribute more to economic growth than the so-called consensus anticipates.

Implication: Although the strong manufacturing spread for the first quarter of 1989 is encouraging, it is not enough to cause us to switch off our yellow light on the economy. We remain concerned about the deteriorating trend in the economy-wide spreads and the Fed's tight monetary policy.

This said, we must repeat that while our yellow light indicates some economic weakness, it does not signal a recession in 1989.

– Steve H. Hanke

Chart 4
Supply-Side Spreads (Rates of Change)

Period	Economy-Wide	Manufacturing
85 1	1.8%	6.9%
2	1.4	9.5
3	2.7	7.5
4	2.0	7.9
86 1	4.7%	7.3%
2	3.5	3.7
3	2.0	3.7
4	3.1	3.4
87 1	0.0%	5.7%
2	1.8	8.5
3	4.1	9.7
4	3.8	9.6
88 1	4.8%	7.9%
2	2.1	6.5
3	1.1	7.0
4	1.7	6.6
89 1	0.1%	7.8%

Notes 1) Rates of Change are calculated on a year-over-year basis.
2) Supply-side spreads (=) percent change in productivity (+) percent change in prices (-) percent change in unit labor costs.

EURODOLLAR FUTURES

Take added protection

The lower-than-expected PPI figure coming on the heels of a batch of statistics indicating that the economy had been slowing down considerably found LIBOR rates at one point down to 9½%. They have recently settled at 9-11/16%, almost flat with Fed funds.

As our article on the economy points out ("A note on Supply Side Spreads"), the economy is unlikely to fall into recession this year. In fact, it is entirely possible that the wide positive spreads in manufacturing will give the economy another "lift." This could convince the Fed to stay the course, at least for now. On the other hand, the US dollar strength (discussed in detail in our opening comments) may put the Fed in the uncomfortable position of having to coordinate a narrowing of interest rate differentials, implying a slight reduction in Fed funds.

STRATEGY: *The case for higher rates outlined above still outweighs the case for low rates (coordination to stop the dollar advance). Nevertheless, we are taking added protection and suggest lowering stops on June '89 Euros to 90.60, close only. If not stopped out, roll June '89 short positions to September '89 on June's last day of trading.*

Chart 5 – EURODOLLAR RATES - 3 MONTHS

STOCK INDEX FUTURES

Rising bullishness

The move beyond the two-thirds retractment of the August '87 to December '87 shakeout (discussed in our March and April issues) ushered in a new phase of the bull move.

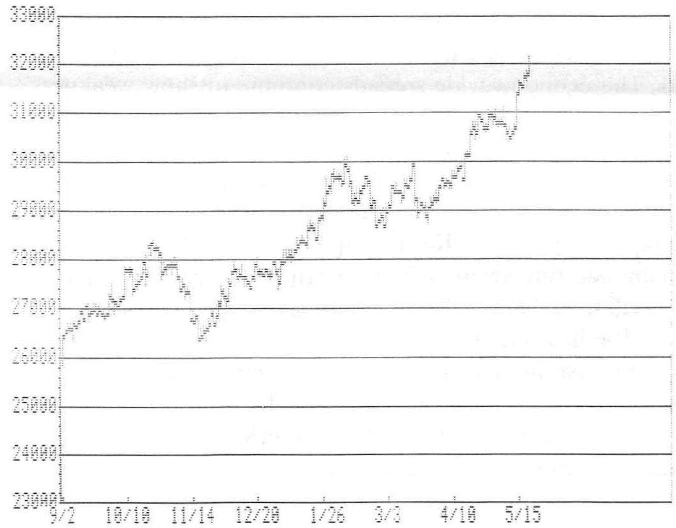
The pace of the advance quickened last week, and the bullish temperature rose. Volume swelled to 231 million shares on the Big Board compared with 191 million the previous week. The consensus of bullish futures advisors rose to 58% for the first time since Oct. 18, 1988, which coincidentally was a market peak before an intermediate decline that lasted approximately four weeks and 170 Dow points.

The strong dollar surely makes the US stock market a very attractive investment to foreigners, and it also removes immediate concern about rising interest rates. The US stock market is not cheap by any normal valuation yardsticks (3.4% dividend yields, trading at 240% of book value) except, as discussed last month, as a gigantic takeover target, in which case attention should be paid to pretax cash flows (still positive *vis à vis* financing cost, although junk bond financing costs have skyrocketed of late) and replacement costs (becoming marginal).

Be that as it may, with the Dow Transportation index at a new *all-time high* and the Nasdaq Composite within only 3% of its all-time high, it is a foregone conclusion that we will be testing the old Dow Industrial high of 2746 in the not-too-distant future. In the process, the market is likely to suffer at least one significant intermediate setback.

STRATEGY: *We are long June S&P futures, as per last month's advice at* 30390 *and long June 310 call options at* 350. *Raise stops on June futures to 31800, good anytime. Keep posted, as this intermediate move is nearly complete.*

Chart 6 – CME S&P 500 INDEX NOV '89



ENERGY COMPLEX

The party is over

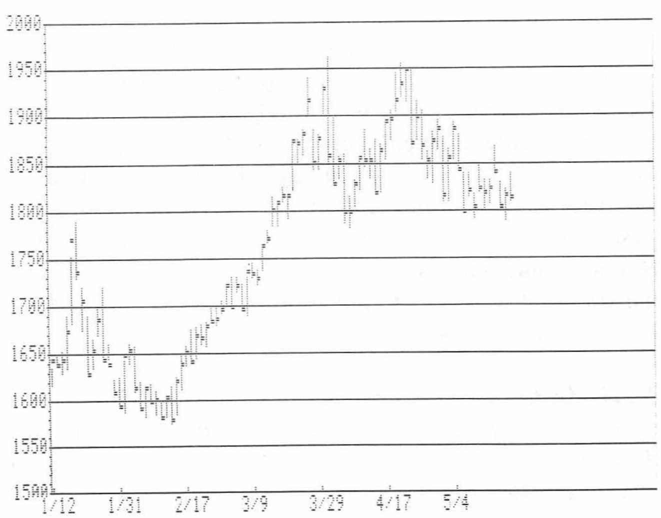
Opec continues to overproduce and is likely to have a very difficult time reconciling requests for higher quotas in the upcoming June meeting. North Sea production, after hitting a nadir of 1.6 million barrels per day (b/d) in May — a result of an unusual series of accidents — is gradually on the mend: By August, average output should reach 2.4 million b/d, 300,000 barrels per day higher than in August 1988. Refining profit margins have begun to narrow, indicating that final demand has eased.

After the expiration of the June '89 contract (Monday, May 22), prices should head significantly lower in coming months. We expect a test of the early '86 and late '88 lows by the end of the year.

STRATEGY: *On May 12 we reinstated short positions in the August '89 contract, placing initial stops at 1950, good anytime. August puts first purchased at just under $1barrel on* April 6 *have been maintained (despite our advice to cover short June positions at 20.50, an event that was triggered on April 18); they have preserved most of the time premiums as a result of an increase in implied volatilities.*

Chart 7

NYME CRUDE LIGHT AUG '89



GOLD

The golden bear

The bear market continues as outlined in our September 18 issue ("The chickens come home to roost"), which concluded that in *real terms*, gold would have to drop to the $200 to $240/oz. area.

We implemented this investment strategy by recommending two spreads: long 2 CRB/short 7 gold contracts; and long 5 December '89 silver/short 4 December '89 gold.

The first spread (Chart 8) has been immensely profitable. The second one has barely broken even as silver prices have paralleled gold's decline (Chart 9).

STRATEGY: *Maintain both spreads, raise stops to .58 on the CRB/gold spread, and maintain 69.5 stops on December gold/December silver spread.*

Chart 8
CRB/GOLD

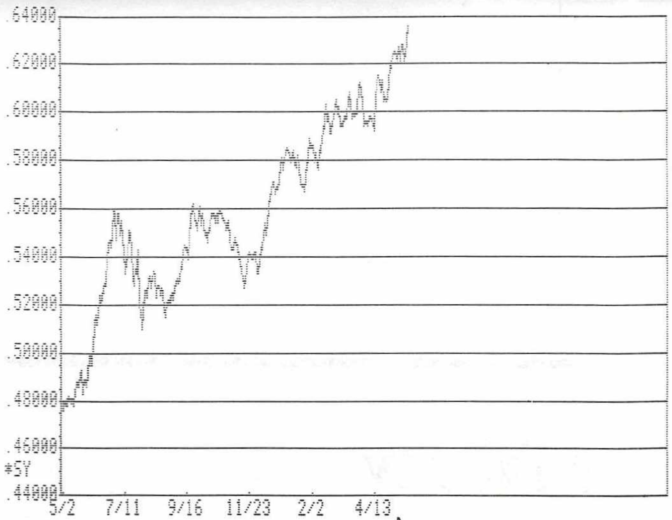
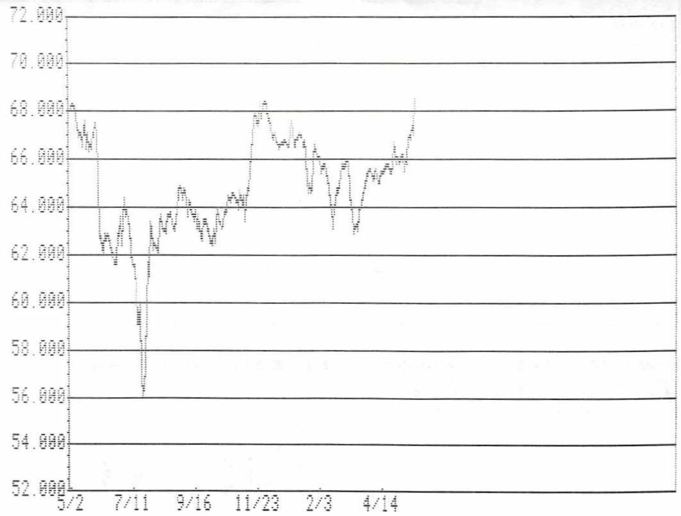


Chart 9
GOLD/SILVER



PLATINUM

Profit target: $100 an ounce

Each may, Johnson Matthey (J.M.), the British refiner and platinum fabricator with close ties to South Africa's largest producer, Rustenburg Mines, unveils its annual report on the white metal. This year their report, *Platinum 1989*, was released in New York on May 15. Since then, platinum prices have been in a nosedive, *and we have been stopped out of our position.*

This post-report price action might lead us to conclude that the J.M. report contained some bearish news. However, a reading of *Platinum 1989* does not indicate bearish news. To the contrary, the always-conservative J.M. has issued a report that is biased toward bullish conclusions.

As Chart 10 shows, 1988 was a good year, with demand increasing by 10%, supply advancing by 3%, and stock reductions increasing by almost 110%. Indeed, it was the fourth consecutive year in which a demand-supply deficit was recorded.

As it turns out, J.M.'s price forecast for 1988 wasn't too bad either. In May 1988, J.M. concluded that 1988 platinum prices would have a range of $450 to $550 per ounce. At the time, we thought this range was too low (see *FC&CC* May 29, 1988). However, although a bit conservative, J.M.'s forecast performed well. The 1988 platinum price range was between roughly $450 and $650 per ounce. The average 1988 London price was $530 per ounce, which was $25 per ounce lower than the average for 1987.

What does the future according to J.M. hold? J.M. forecast deficits for 1989 (although they note that it might not be as large as 1988), 1990, and perhaps 1991. If these occur, they would result in a significant seven-year string of deficits. This is, indeed, a bullish appraisal of the market. To some extent, this appraisal is reflected in J.M.'s 1989 platinum price forecast, which has the 1989 range set at $500 to $600 per ounce, or $50 per ounce higher than the range contained in the J.M. 1988 forecast.

At this writing, we see no reason not to take J.M.'s *Platinum 1989* report at face value. This suggests that investors who purchase contracts at around $500 per ounce will be able to realize, at some point during the remainder of 1989, profits of $100 per ounce. Indeed our reading of J.M.'s conservative history suggests that their reports fail to fully reflect upside price potential, and that potential profits might exceed a $100 target.

STRATEGY: *Keep posted to the Hotline Update for a reentry recommendation.*

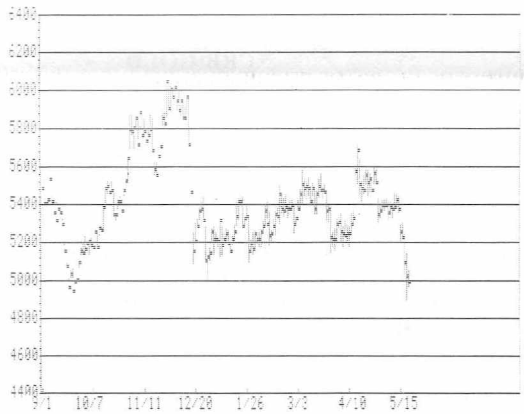
– Steve H. Hanke

Chart 10
Platinum Supply and Demand: Western World

Supply	1979	1980	1981	1982	1983	1984	1985	1986	1987	1988
					000oz.					
South Africa	2.180	2.320	1.800	1.960	2.070	2.280	2.340	2.350	2.520	2.560
Canada	130	130	130	120	80	150	150	150	140	145
Others	30	30	30	30	40	40	40	40	40	95
	2.340	2.480	1.960	2.110	2.190	2.470	2.530	2.540	2.700	2.800
USSR sales	460	340	370	380	290	250	230	290	400	400
Total supply	2.800	2.820	2.330	2.490	2.480	2.720	2.760	2.830	3.100	3.200
Demand by region										
Western Europe	430	290	420	330	330	400	400	470	560	545
Japan	920	940	1.150	1.050	950	1.140	1.250	1.010	1.650	1.915
North America	1.340	980	700	710	720	910	1.010	1.190	900	850
Rest of Western World	160	120	160	230	180	180	170	170	180	310
	2.850	2.330	2.430	2.320	2.180	2.630	2.830	2.840	3.290	3.620
Western sales to Comecon/China	30	30	30	30	20	30	30	40	30	40
Total demand	2.880	2.360	2.460	2.350	2.200	2.660	2.860	2.880	3.320	3.660
Movements in stocks	(80)	460	(130)	140	280	60	(100)	(50)	(220)	(460)
	2.800	2.820	2.330	2.490	2.480	2.720	2.760	2.830	3.100	3.200

Soure: *Johnson Matthey*

Chart 11
NYME PLATINUM JLY '89



THE ECONOMY

The free reserve fallacy

For some months, we have noted and analyzed the Fed's tightening of monetary policy. As evidence of this tightening policy, we must look no further than the growth rates of key monetary aggregates (see Charts 12 and 13). The growth rates of the monetary base and M2 have slowed sharply in the past nine months. For example, at the start of August 1988 the one-year growth rate for the monetary base was 7.7% and that for M2 was 6.1% Since then, the rates have fallen by about 40% (to 4.7%) and over 50% (to 2.9%), respectively. Given this evidence, we were rather puzzled when a leading Wall Street firm speculated that perhaps the Fed has not been applying the monetary brakes. To support this view, the firm presented free reserve data (total reserves minus required reserves minus borrowed reserves) from 1980 to the present. As Chart 14 shows, free reserves were negative through most of the 1980-85 period, and since then, they have been positive.

Given what happens to be contradictory evidence (monetary aggregates versus free reserves), we set out to try to solve the puzzle. Our first task was to understand the theory behind equating positive free reserves with loose monetary policy and negative free reserves with tight policy. This theory was developed in the 1930s and is associated with, among others, the works of Dr. Winfield W. Riefler. The basic theory of the "reserve position doctrine" is that excess reserves (total reserves minus required reserves) represent a potential for expanding credit, and borrowing from the Fed discount window represents a potential for reducing credit.

The conclusion that borrowings represent a potential for reducing credit hinges on an assumption about banks' behavior. The reserve position doctrine assumes that with regard to borrowings, banks are not profit maximizers because they have an ingrained aversion to continuous borrowing from the Fed, even if discount rates (borrowing rates) are much less than market rates (lending rates). In consequence of this assumption, it is argued that banks always want to pay off loans from the Fed rapidly, and that, to do this, they will reduce loans. Hence, borrowings contain the seeds of credit contraction.

In conclusion, then, excess reserves are viewed as an indicator of potential credit expansion and borrowings are an indicator of potential credit contraction. It follows, therefore, that the difference between them, which is free reserves, is an indicator of whether monetary policy is loose or tight. So the theory of the reserve position doctrine goes.

Like other economic theories, the reserve position doctrine has a following on Wall Street. Indeed, a widely used handbook, *The Dow-Jones-Irwin Guide to Using The Wall Street Journal* (1987), contains a chapter titled "The Federal Reserve System." This chapter is entirely devoted to explaining why free reserves are a vital indicator of the Fed's tightness or looseness. The analysis in this chapter concludes as follows: "free reserves are positive when the Fed pursues expansionary policy...and free reserves are negative when the Fed policy turns contractionary."

Does it hold water?

So much for the theory and the fact that it has many followers. The issue remains: does the theory hold water? Some light was shed on this question in 1959 by Professor Milton Friedman. During his Millar Lectures at Fordham University, Professor Friedman argued that the reserve position doctrine was a fallacy. Since free reserves are the difference between excess reserves and borrowings, arithmetically, any given level of free reserves is consistent with either a rapid increase or decrease in the supply of money. Hence, any given level of free reserves is consistent with loose or tight monetary policy.

The following examples illustrate the point raised by Professor Friedman. In Example 1, we start with total reserves of $500 and free reserves of $50. Then, total reserves are increased from $500 to $1,000. Hence, the monetary base (high-powered money) is increased by $500 and monetary policy has become less restrictive. Recall, the monetary base consists of total reserves plus currency. However, if we are monitoring free reserves as an indicator of monetary policy, we would conclude that there was no change in monetary policy because free reserves remained at $50.

Example 1: Monetary Expansion

	Position 1	Position 2
Total reserves	$500	$1,000
Required reserves	- 400	- 800
Excess reserves	100	200
Borrowings	- 50	- 150
Free reserves	50	50

In Example 2, we start with total reserves of $500 and free reserves of $50. Then, total reserves are reduced from $500 to $250. Hence, the monetary base is reduced by $250, and monetary policy has become more restrictive. However, free reserves remain constant at $50. If we are monitoring free reserves as an indicator of monetary policy, we would conclude that there was no change in policy, when, in fact, policy has become tighter.

Example 2: Monetary Contraction

	Position 1	Position 2
Total reserves	$500	$250
Required reserves	- 400	- 200
Excess reserves	100	50
Borrowings	- 50	- 0
Free reserves	50	50

Professor Friedman's comments about the arithmetic of free reserves expose the basic fallacy of the free reserve doctrine. Taking the analysis a step further, one of Professor Friedman's students at the University of Chicago, Dr. A. James Meigs, prepared a book, *Free Reserves and The Money Supply (1962)*. This little book contains high-powered arguments and data that completely destroy the reserve position doctrine and the notion that free reserves are a reliable indicator of Fed policy.

Dr. Meigs founds that banks do not act as they were assumed to act under the reserve position doctrine. Indeed, banks are profit maximizers. In consequence, their demand for free reserves is a function of interest rates. Specifically, the demand for free reserves is a negative function of the spread between market yields (the federal funds rate) and the Fed's discount rate. For example, when the spread between the federal funds rate and the discount rate widens, the opportunity cost of holding excess reserves (not lending them at a profitable spread) becomes greater and the profits from borrowing from the Fed's discount window become larger. The combination of wanting to hold fewer excess reserves and to increase borrowings from the discount window both act to reduce the desired level of free reserves. If the spread between the federal funds rate and the discount rate narrows, then the desired level of free reserves increases.

In the context of Dr. Meigs' findings about the demand for free reserves, let's consider how far off base we could be if we used free reserves as an indicator of monetary policy. Assume that the discount rate is moved to 1%, and the federal funds rate remains at its current level. In this case, the desired level of free reserves would move down sharply. If we were using free reserves as an indicator of monetary policy, we would conclude that the Fed had tightened policy. However, this would be a false indicator, because a drop of the discount rate to 1% represents a radical loosening of policy. Alternatively, if the discount rate is raised to 20% and the federal funds rate remains at its current level, the desired level of free reserves would increase sharply. In this case the free reserve indicator would imply a loosening of policy. Again, this would represent a false indicator because a discount increase to 20% represents a radical tightening of policy.

Explaining positive free reserves

Given our analysis of free reserves, can we explain why free reserves have remained at positive levels during a period in which the Fed has been tightening (reducing the growth rate of monetary aggregates)? This can be accomplished with the use of Chart 15. Assume the interest rate spread is at OA. Then, with the demand curve at D_1, the desired level of free reserves is at a positive level OX. Now, if the interest rate spread increases to OB, which characterizes the change over the past nine months, and the demand curve stays the same (at D_1), then the desired level of free reserves moves to a negative level OY.

But the desired free reserves have not dropped since the interest rate spread increased. Rather, they have stayed at about the same level. This can be explained in the context of our analysis. At the same time that the spread increased from OA to OB, the demand curve shifted from D_1 to D_2. Hence, the desired level of free reserves for any interest rate spread level is higher now than before the demand shift. In consequence of the spread increase to OB and the demand shift to D_2, the desired level of free reserves has stayed at about the same level (OX on Chart 15).

The only issue to explain is why the demand curve for free reserves has increased. In our view, this has occurred because the average level of deposit drains and the variance of these drains from banks has increased. In consequence, banks' demand for free reserves (a liquidity cushion) at all interest rate spread levels has increased.

Implication: Free reserves have been totally discredited and should be disregarded as an indicator of monetary policy. The relevant reserve number to follow is "total reserves," since they are part of the monetary base.

– Steve H. Hanke

Chart 12

MONETARY BASE GROWTH RATE

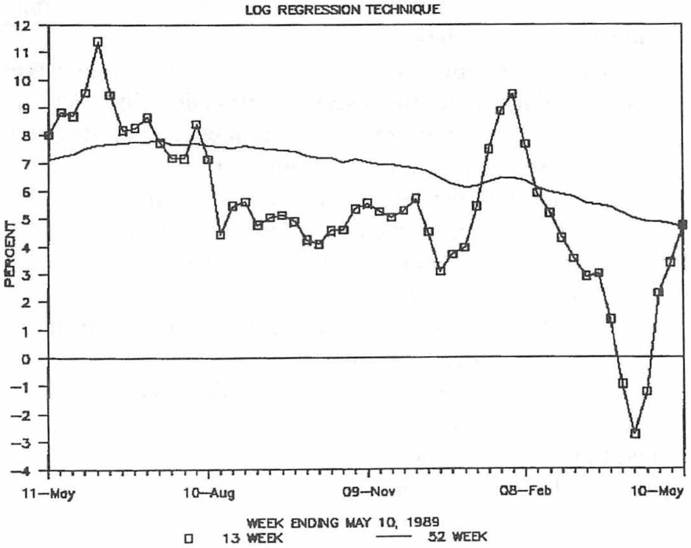


Chart 13

M2 GROWTH RATE

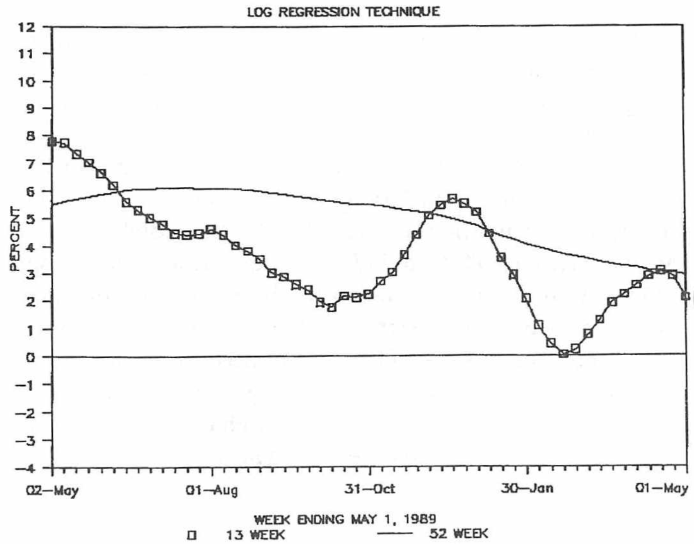


Chart 14

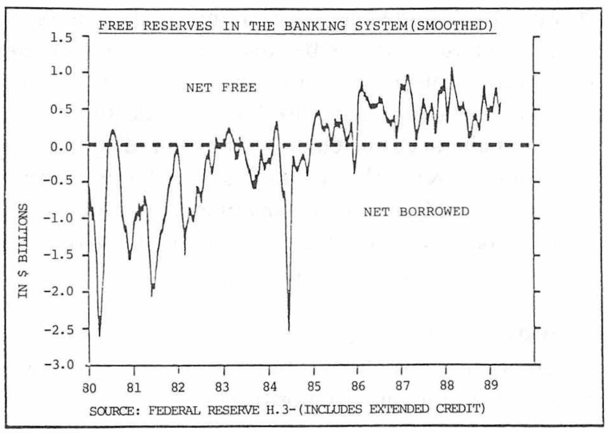
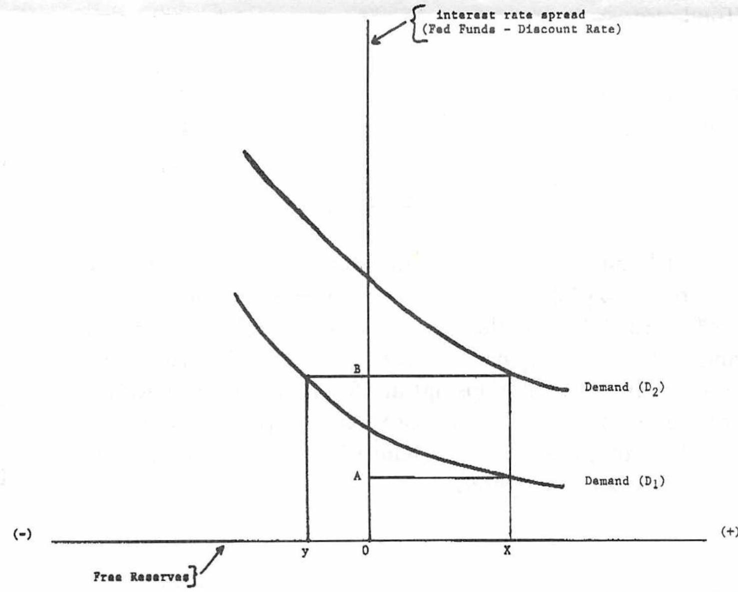


Chart 15

THE DEMAND FOR FREE RESERVES



FRIEDBERG CAPITAL MARKETS

Summertime convertibles

We are adding yet another US-dollar-denominated convertible bond to our selection.

Alliant Computer Systems Corp.

Coupon: 7.25% (semi annual) convertible due 15/05/12
Yield to maturity: 15.57%
Price: (subject to change) 48 1/4
Traded: US over-the-counter market.
Conversion terms: 25.157 shares per $1,000 bond, or convertible at $39.75 per share. Recent stock price $5 3/8.

Alliant Computer develops and markets easy-to-use, accessible super computers that overcome the limitations of traditional super computing. Typical application for all Alliant Systems include computational chemistry, simulation and control, mechanical engineering, and VLSI design.

Net earnings have been erratic:

(000's)	1988	1987	1986
	36,243 (loss)	7,065	3,552

Debt Coverage Ratio Analysis:

	1988	1987	1986
Net income before income tax	39,395 (loss)	6,004	3,927
Add back:			
Interest expense	3,790	2,386	219
Depreciation and amortization	6,936	4,593	2,522
Restructuring and other non-cash charges	17,061		
Total	11,608 (loss)	12,983	6,668
Debt service	3,790	2,386	219
Excess	negative	10,597	6,449
Coverage ratio	none	5.44:1	30:1

For the first quarter of 1989, the company reported net income before extraordinary items of $77,000, or $0.01 per share, compared to $265,000, or $0.02 per share, for the corresponding period of 1988.

Other relevant statistics (Fiscal 1988)

Net sales	$64,829,000
Current assets	$83,171,000 (March 31, 1989)
Current liabilities	$27,338,000 (March 31, 1989)
Long-term debt	$41,351,000 (March 31, 1989)
Book value per share	$2
Earnings per share	$3.00 (loss)
Long-term debt as % of total capitalization	44.3%
Total debt — tangible equity	73.4%
Bonds outstanding	$39,200,000 (issue size — $50,000,000)
Investment value	44 1/4 (source: Merrill Lynch)
Rating:	B3 (Moody's)
Shares outstanding	12,302,386

Although last year's debt service was non-existent, the company is confident that its restructuring efforts will contribute to much improved results for the coming years. Moreover, the company has more cash on hand ($45.8 million) than the *par* value of the debentures due ($39.2 million). There is a mandatory sinking fund commencing in 1998, but with the bonds trading at a deep discount, the company could repurchase them in the open market as they did in 1988 and 1987 when they realized gains of $2,953,000 and $1,201,000 respectively. It will need only $19.6 million to repurchase all of its outstanding bonds, and in the process it would realize a profit of over $19 million. This provides ample support to investors.

Sunrise Medical Inc.: excellent results

For the recently released third-quarter report (March 31, 1989), the company reported:

- Sales were up 17% from the prior year to $39,340,000.
- All measurements of cash flow and asset management continued to show favorable trends.
- Total long-term debt is now $11.7 million lower than at this time last year.

The bond has moved up to 67 from our initial buy recommendation (last month) of 56 3/4. At present levels, the bonds yield 15.13% to maturity and are still considered attractive.

Recommended bond portfolio allocation:

New Zealand dollar bonds:	5%
US dollar floating-rate notes:	85%
US dollar high-yield convertible bonds:	10%

Chart 16
FOREIGN CURRENCY BONDS

Date: May 18, 1989

We offer the following Bonds subject to change without prior notice: Minimum amount US$5,000 (Cdn.$7,000)

PAY ISSUER/MTY.DATE/COUPON	BID	OFFER	CURRENT ANN. YIELD TO MTY	LAST PAY NEXT PAY DATE
CANADIAN DOLLAR DENOMINATED BONDS				
GOVERNMENT OF CANADA (semi annual) 01/02/90 13 1/4%	100.93 -	101.33	11.20	01/02/89-01/08/89
NEW ZEALAND DOLLAR DENOMINATED BONDS				
TORONTO DOMINION BANK 02/04/90 18% RRSP eligible	102 1/2-	103 1/2	13.23	04/02/89-04/02/90
MCDONALD'S (semi annual) 15/08/90 16 3/4%	103 -	104	13.49	15/02/89-15/08/89
TOURIST HOTEL (N.Z.) 04/06/93 zero coupon	56 1/2-	58 1/2	14.23	matures -04/06/93
AUSTRALIAN DOLLAR DENOMINATED BONDS				
COMMONWEALTH BANK OF AUSTRALIA 01/07/94 14%	97 1/8-	98 1/8	14.50	01/07/88-01/07/89
WORLD BANK 15/03/93 12 3/4% RRSP eligible	98 3/4-	99 3/4	12.74	15/03/89-15/03/90
CAN.IMP.BANK OF COMMERCE 13/03/91 13% RRSP eligible	93 1/4-	-	-	13/03/89-13/03/90
DANISH KRONE DENOMINATED BONDS				
STOCKHOLM 10/11/91 10 5/8%	101 7/8-	102 5/8	9.33	10/11/88-10/11/89
BRITISH POUND DENOMINATED BONDS				
KGDM of SWEDEN 14/4/93 9 3/8%	93 5/8-	94 3/8	11.22	14/04/89-14/04/90
DEUTSCHE MARK DENOMINATED BONDS				
QUEBEC HYDRO 1/5/96 5 1/2 RRSP eligible	92 -	92 3/4	6.84	01/05/89-01/05/90
SWISS FRANC DENOMINATED BONDS				
GOVT.OF AUSTRALIA 30/10/98 5%	94 1/4-	95	5.70	30/10/88-30/10/89
JAPANESE YEN DENOMINATED BONDS				
GOVT.OF CANADA 23/7/93 5 5/8% RRSP eligible	101 3/4-	102 1/2	4.90	23/07/88-23/07/89

PAY ISSUER/MTY.DATE/COUPON	BID	OFFER	CURRENT ANN. YIELD TO MTY	LAST PAY NEXT PAY DATE
U.S.DOLLAR DENOMINATED FIXED CONVERTIBLE BONDS				
PACIFIC SCIENTIFIC 7 3/4% (semi ann.)15/06/03 CV Sh's per $1000 bond 26.32 @$38 p/sh.	66 1/2-	68	13.10	15/12/88-15/06/89
SUNRISE MEDICAL INC.7.25% 26/6/96 CV sh's per $1000 bond 56.738 @$ 17.625 p/sh.	64 -	67	15.13	26/06/88-26/06/89
U.S.DOLLAR DENOMINATED FIXED RATE BONDS				
ALBERTA 9/12/91 7 3/8% RRSP eligible	95 3/8-	96 1/8	9.11	09/12/88-09/12/89
SOUTHMARK CORP.(semi-ann.) 1/11/89 10 7/8%	55 -	57	N/A	01/05/89-01/11/89
U.S.DOLLAR DENOMINATED FLOATING RATE NOTES				
ISSUER MAT.DATE COUPON	BID	OFFER	CUR.COUP.	
UNITED KINGDOM 24/9/96 3 mo.LIBID-1/8 (quarterly)	100.32-	100.62	10 5/16%	28/03/89-28/06/89
REPUBLIC OF ITALY 30/4/93 3 mo Limean (quarterly)	99.20-	99.60	10.0%	28/04/89-31/07/89
REPUBLIC OF PORTUGAL 8/12/93 (semi annual) 6 mo LIBOR +5 B.P.	99.72-	100.02	9.425%	08/12/88-08/06/89
L.D.C. PAPER DENOMINATED IN U.S.DOLLARS				
ISSUER MAT.DATE/COUPON	BID	OFFER	CUR.COUP.	
BANCO CENTRAL De CHILE (restructured) 12mo.LIBOR +1 1/8 (annually)	57 -	60½	10 11/16 * 17.67%	20/01/89-20/01/90
ARGENTINA 15/2/92 BONEX ser.82 LIBOR (sem.ann.)	.6880-	.7180	9 5/8 ** 27.68%	15/02/89-15/08/90

amortized:12½% of principal paid yearly

For further information and current prices please call:
FRIEDBERG CAPITAL MARKETS (416) 364-2700 F/MICHCM

Chart 17
Breakeven exchange rates for US$ – based investor

This analysis shows a "snapshot" of the relationship between interest rate differentials and rates of exchange. The breakeven rate measures how far the foreign currency has to devalue (for NZ$, A$, DKr) or revalue (for DM, SF, JY) before the interest rate advantage/disadvantage is overcome by currency depreciation/appreciation. **BOND YIELDS AND RATES OF EXCHANGE AS OF MAY 18/89.**

	U.S. $	NEW ZEALAND $	AUSTRALIAN $	DEUTSCHEMARK	SWISS FRANC	JAPANESE YEN	DANISH KRONE
1 year	8.94%	Toronto Dominion 02/04/90, yields 13.23% (.578 NZ/US)					
2 year	9.01%						Stockholm 10⅝% 10/11/91, yields 9.33% (7.70 Dkr/US)
4 year	8.93%	Tourist Hotel 0% 4/6/93, yields 14.23% (.497 NZ/US)	World Bank 12¾% 15/3/93, yields 12.74% (.661 A$/US)			Canada 5⅝% 23/7/93, yields 4.90% (125.35 US/JY)	
5 year	8.91%						
6 year	8.88%						
7 year	8.84%			Quebec Hydro 5½% 1/5/96, yields 6.84% (1.73 US/DM)			
10 year	8.89%				Australia 57. 30/10/98, yields 5.70% (1.32 US/SF)		
Spot Exchange Rate	N/A	.6015	.7585	1.971	1.7605	138.95	7.663

**For example, in parentheses, since a US$ based investor would receive 429 basis points (1323-894) by holding the Tor. Dom. 18% NZ$ bond, the NZ$ can depreciate to .578 NZ/US from the present spot exchange rate of .6015 NZ/US over the next 1 year for the NZ$ investment to break even with current US$ rates of interest. Assumes that bonds are held to maturity, and coupons are reinvested.

FOREX RATES & UPDATE

Currency	*Spot*	*3-Month*	*12-Month*	*Comments vis à vis US$*	*Comments vis à vis DM (Spot DM: 1.9750)*
Australian dollar	.7630-.7640	.7485-.7497	.7115-.7135	Neutral	Neutral
Belgian franc	41.15-41.20	41.00-41.09	40.68-40.83	Remain short**	Neutral
Danish krone	7.6640-7.6690	7.6550-7.6650	7.6530-7.6710	Remain short**	Neutral
Dutch guilder	2.2160-2.2170	2.2030-2.2045	2.1725-2.1750	Remain short**	Neutral
Greek drachma	167.07-167.17	172.27-175.37	181.07-191.67	Remain short	Remain short
*Hong Kong dollar	7.7850-7.7880	7.7850-7.7900	7.8100-7.8230	Neutral	Buy***
Irish punt	1.3565-1.3580	1.3542-1.3547	1.3565-1.3610	Remain short**	Neutral
Italian lira	1433-1434	1441-1442	1463-1468	Remain short**	Neutral
Kuwaiti dinar	.29430-.29480	.29325-.29420	.29043-.29261	Remain short	Neutral
Malaysian ringgit	2.6860-2.6880	2.6680-2.6730	2.6210-2.6280	Neutral	Neutral
New Zealand dollar	.6020-.6040	.5960-.5990	.5785-.5845	Neutral	Neutral
*Norwegian krone	7.10-7.11	7.12-7.13	7.17-7.19	Sell***	Neutral
*Portugese escudo	162.55-162.85	163.80-164.85	168.30-171.60	Sell***	Neutral
Saudi Arabian riyal	3.7490-3.7500	3.7490-3.7510	3.7490-3.7520	Remain short	Remain short
*Singapore dollar	1.9630-1.9650	1.9450-1.9485	1.8980-1.9090	Liquidate	Liquidate
*Spanish peseta	122.70-122.80	123.80-124.00	118.25-118.65	Sell***	Neutral
*Swedish krona	6.63-6.64	6.64-6.65	6.72-6.74	Sell***	Neutral

Explanatory Notes

*Indicates change in recommendation from last issue.

**As per Hotline Update of May 8 and May 19, 1989.

***Liquidate on the basis of DM and EMS recommendations, when and if issued on the hotline.

Currency expected to firm against both currencies.	Buy	Buy
Currency expected to strengthen against US$ and weaken against DM.	Buy	Sell
Currency expected to weaken against both major currencies.	Sell	Sell
Currency expected to weaken against US$, but strengthen against DM.	Sell	Buy
Term used to liquidate short position but does not imply a new buy recommendation.	Cover	
Term used to indicate sale advice of previous long position, but does not imply a new short sale recommendation.	Liquidate	

HOTLINE UPDATE

Monday, April 17, 9:15 a.m.:
This is a flash update. Cover short June S&P at market and liquidate long put positions. In addition we are suggesting going long June 310 S&P call options at market.

Tuesday, April 18:
One new recommendation: Buy July sugar at market, risking 1095, close only.
The market letter is in the mail.

Wednesday, April 19:
This is a wrap-up of the week's activities. There will be no broadcast on Friday this week.

1. As of Monday morning's flash update, we have covered short S&P positions and sold long put options. We also recommend the purchase of June 310 S&P call options.
2. As of Tuesday's update, we are long July sugar at approximately 1228 with stops at 1095, close only. The market letter is in the mail. (I repeat, there will be no broadcast Friday, April 21).

Tuesday, April 25:
There are no changes or new recommendations.

Friday, April 28:
No changes or new recommendations.

Tuesday, May 2:
There are no changes or new recommendations.

Friday, May 5:
Sell June Eurodollar futures at 9020 or better and risk 9076, close only. Holders of September Eurodollar puts may want to consider selling their puts, recovering a good portion of the time premium and simultaneously establishing a short position in Eurodollar futures.

Monday, May 8, 1:30 p.m.:
This is a flash update. Accept profits on long US dollar positions by covering JY, DM, SF, and other EMS currencies at market. Stay posted for reentry point.

Tuesday, May 9:
One flash update this week: At 1:30 p.m., Monday, May 8, we recommended accepting profits on long US $ positions by covering short JY, DM, SF, and other EMS currencies at market. Stay posted for reentry point.

Flash update, Wednesday, May 10, 10:10 a.m.:
Reinstate short positions in oil futures market. Sell August NY crude at market, placing initial stops at 1950, good anytime.

Friday, May 12:

1. As per our flash update on Monday, May 8, we have accepted profits on long US$ positions by covering short positions in JY, DM, SF, and other EMS currencies at market.
2. As per Wednesday, May 10 flash update, we have reinstated short positions in crude oil futures by selling August crude and placing stops at 1950, good anytime.

Tuesday, May 16:
No changes or new recommendations.

Flash update, Friday, May 19, 9:50 a.m.:
Refusal of the German and Japanese central banks to take effective steps to contain the dollar — that is, raise interest rates — suggests that we should get back into the market and establish new short positions in September JY, SF, DM, and other EMS currencies at the market. Be prepared to add to these short positions after any significant intervention package.

Friday, May 19:
This morning at 9:50 a.m. we put out the following flash update: Refusal of the German and Japanese central banks to take effective steps to contain the dollar — that is, raise interest rates — suggests that we should get back into the market and establish new short positions in September JY, SF, DM, and other EMS currencies at the market. Be prepared to add to these short positions after any significant intervention package.
There are no other changes or recommendations.
Have a nice weekend.

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