

# FRIEDBERG'S

## COMMODITY & CURRENCY COMMENTS

Friedberg Commodity Management Inc.



Volume 11, No. 8 September 16, 1990

### The bitter fruits of easy money

In the early days of 1989, the Bank of Japan began to implement a gradual, albeit timid, increase in interest rates to combat the double-digit growth of money, a weakening yen, and a spiralling asset bubble.

Because the Great Credit Inflation of the '80s did not have an appreciable impact on consumer prices, the market was temporarily lulled into believing that inflation was not a problem. As a result, long term bond yields remained relatively subdued allowing a 140-basis-point inverse yield curve to develop between three-month Euro-yen and 10-year government bonds.

Since the end of 1989, the inversion has flattened; the ascent of money market rates has been slowed by a Central Bank terrified at the collapse in stock prices and its impact on bank solvency, and long-term rates have, with increasing speed, begun to take note of the fact that they cannot, indefinitely, stay below the rate of money and credit growth.

As of this past week, yields on the heavily traded #119 exceed three-month Euro-yen by five basis points. The flattening of the yield curve indicates that the BOJ has, at least temporarily, lost control of monetary policy. Which seems to imply still higher rates down the pike...

While the impact on stock and bond futures is decidedly bearish, the impact on the currency is less clear. On the one hand, the relatively more accommodative BOJ posture permits a continuing high level of growth in nominal demand, causing a further narrowing of the surplus on current account. Since movements in current account are known to track yen fluctuations reasonably well, a weaker yen can be deduced. On the other hand, rising interest rates are producing a positive differential *vis à vis* European currencies and the US dollar, with favorable consequences for the yen.

Given the freedom of capital movements and the large pool of capital in search for *high nominal* yields — tempered only by *clear* signs of overvaluation, a vague and difficult-to-measure condition — we surmise that the capital flows effect will be the dominant one. Therefore, the yen is likely to continue to improve in the weeks and months ahead despite a shrinking current account surplus.

During 1989 and 1990 we benefitted handsomely from the view that the yen would weaken significantly *vis à vis* the DM and the SF. We initiated the cross-trade (long DM (and Swiss franc)/short yen) at around 74 yen/DM (see *FC&CC*

July 23, 1989 "On the US\$ and the yen-DM cross") and maintained it until August 24 (see Hotline Update), bailing out at nearly the high of the move (point "S" in Chart 1).

While our new "bullish" view of the yen therefore represents a dramatic reversal of the successfully-held notion that the yen was bound to depreciate, we are comforted by three additional shreds of favorable evidence: a) among industrialized countries, exchange rates tend to correlate well with differential rates of economic growth — and Japan is clearly growing faster than the US (now mired in a recession) and even Europe (slowed down significantly by tight monetary policies and indigestion problems with East Germany); b) the Yen "acts well" in the face of generally "bearish" oil news; and c) the bullish sentiment, on the DM and SF *vis à vis* the US\$ has become too one-sided, not so with the \$/yen, auguring at the very least a relative improvement over the latter *vis à vis* the former.

In conclusion: much lower Japanese stock and bond prices and a considerably stronger yen.

**STRATEGY:** *Maintain short positions in the yen bond traded on the LIFFE, now rolled over to December '90.*

*Maintain short positions in the stock market via Nikkei futures as suggested in our June 24 issue (then trading at 32,000).*

*Buy December '90 yen at market, placing initial stops at 6775, close only.*

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Contributions by Albert D. Friedberg, Dr. Steve H. Hanke, Daniel A. Gordon, and Michael D. Hart.

Chart 1 – Yen per SF

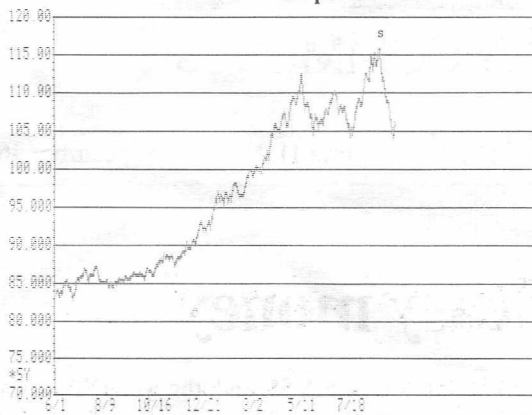


Chart 2 – Yen per DM

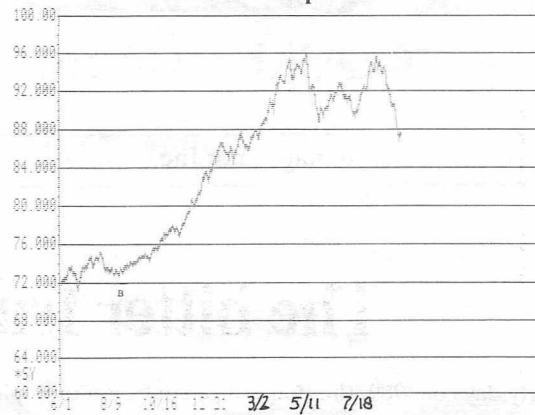


Chart 3 – Nikkei 225 Index Spot

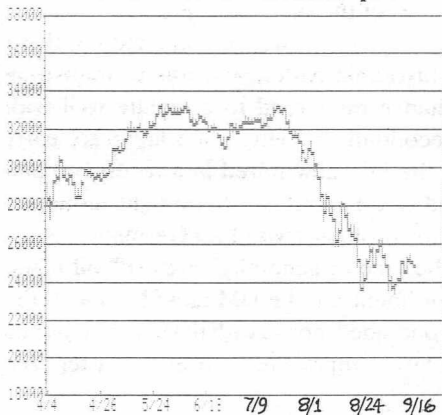


Chart 4 – LIF Japanese Bond Dec '90

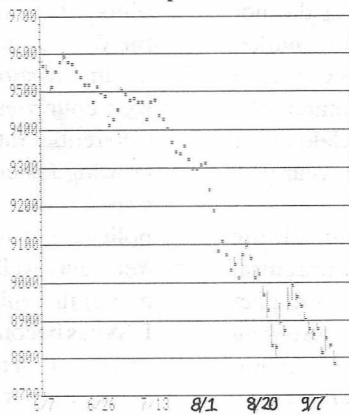


Chart 5 – CME Japanese Yen Dec '90



**STOCK INDEX FUTURES**

**The decline is gathering steam**

Despite the extremely overvalued condition reached in late August, the market was unable to mount a significant rally with the exception of the one-day, 76-point surge of the Dow Industrials on August 27. Declining volume and new lows in breadth (see Chart 6) since, are vivid testimony to the ongoing bear market.

The "R" word is finally pronounceable: Increasingly it has become apparent that the US has entered a business recession, one that is likely to aggravate the ongoing squeeze on corporate profits (see Chart 7). Being forward-looking, stock markets will tend to bottom at or before the end of a recession. Will this recession be any different? Probably not. The uncertainty, however, revolves around the duration and magnitude of the contraction. Knowing that we are in a recession, therefore, does not make stock forecasting any easier.

There are a number of "fundamental" indicators that point to a relative early end to this bear market. The first, and possibly the most important one, is the incipient recovery in banking liquidity (see Chart 8). Although still weak, it is

interesting to note that previous bouts of banking reliquification accompanied the early stages of a bull market (early 1975, early 1980, late 1982, early 1985).

The fact that this most recent uptrend in liquidity has not had as yet a favorable impact on stock prices may be due to the very low absolute level of bank liquidity prevailing at this time. Be that as it may, and in view of the more relaxed, accommodative Fed stance, it is worthwhile keeping an eye on this coincident indicator.

The second is our asset allocation model (see the next article: "Stocks vs. bonds"), which has turned friendly to stocks in the third quarter of 1990 after being in bonds for the first two quarters of the year.

Arguing for a slightly later end to the bear market is the significant drop in consumer confidence (see Chart 9): large enough to presage trouble but still "too high" to indicate a "real bottom." A reading of 45% to 55% may still be months away. The same can be said about the *Bank Credit Analyst's* Debit Loan ratio, which monitors the relationship between money payments and corporate short-term indebtedness. As

Chart 10 shows, the Debit-Loan ratio has fallen significantly, forecasting an *intensifying* squeeze on corporate profits. Market expectations are nowhere near the dramatic *deterioration* about to take place. As an example, the surge in the dividend payout ratio (see Chart 11) reveals "latent" bullishness on the part of chief executives and corporate boardrooms.

The extraordinary build-up of debt of Corporate America (see Chart 12) almost guarantees near-fatal blood-letting. Stock prices, however, need not follow corporate earnings. In fact, it is quite certain that stock prices and earnings will

become divorced from each other near the absolute trough of the recession. It is for this reason that we believe that the indicators discussed above added to a good dosage of contrarian thinking (i.e., sentiment indicators) will become useful guideposts to the art of picking a market bottom.

**STRATEGY:** We liquidated September '90 S&P 500 put options at a substantial profit. We remain short KC Value Line futures, now rolled over to December '90. The decline is once again gathering steam.

Chart 6

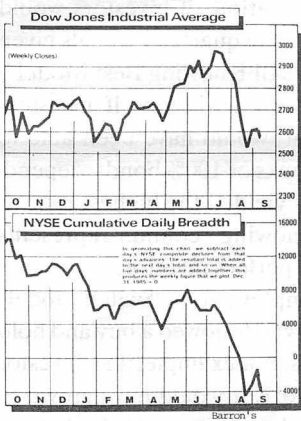


Chart 7

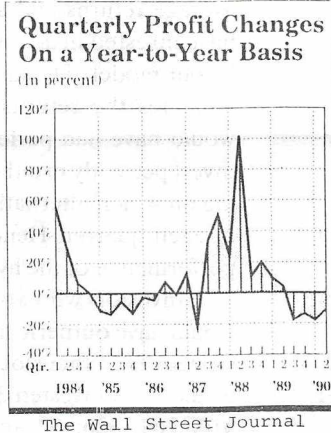


Chart 8

INVESTMENTS/TOTAL LOANS AND INVESTMENTS

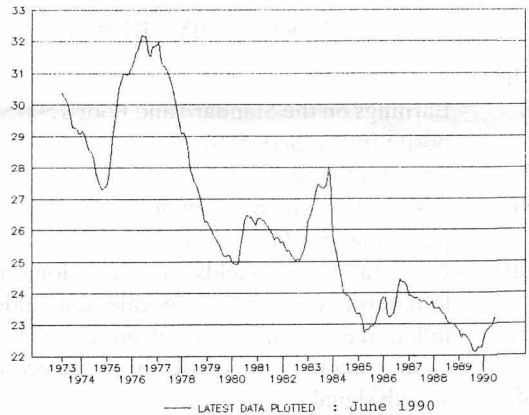
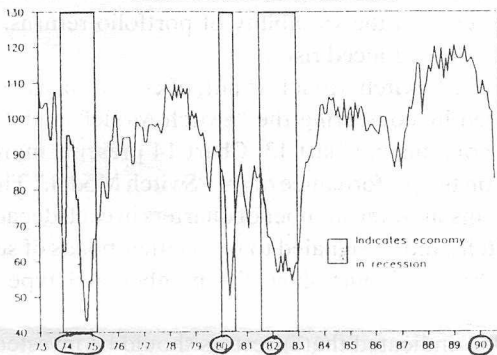


Chart 9

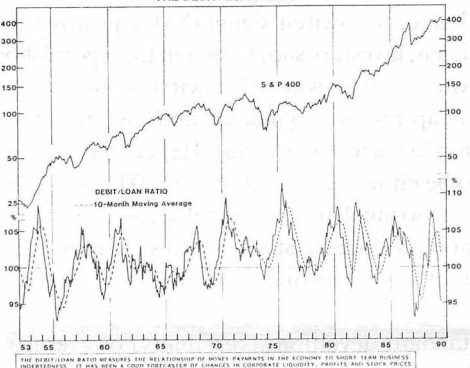
Consumer Confidence Index



Source : The Conference Board  
Chart Prepared By: C.J.Lawrence

Chart 10

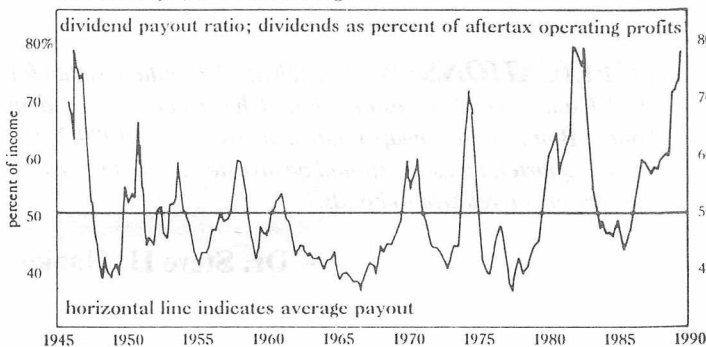
THE DEBIT/LOAN RATIO



Source: The Bank Credit Analyst

Chart 11

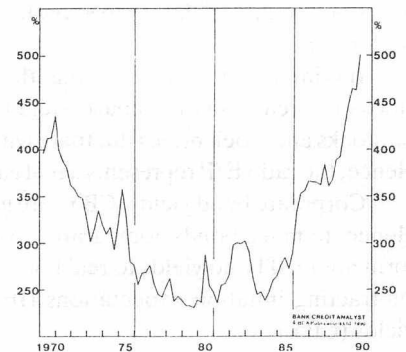
Dividend payout ratios surge



sources: Citibase; Heinemann Economic Research

Chart 12

CORPORATE DEBT BURDEN\*



\* Debt of Nonfinancial Corporations as a % of Net Cash Flow.  
Source: The Bank Credit Analyst.

**MARKET STRATEGY****Stocks vs. bonds**

Over the years, the analytical firepower that has been thrown at the so-called portfolio allocation problem has been impressive. Indeed, we have directed a bit of our firepower at that target. Our work has led us to the following conclusion: The most appropriate model (for us at least) is a rather simple one.

Our model is represented by the following equation:

$$(E/P - RF) - (CBY - IE) = SS$$

where:

- E = Earnings on the Standard and Poor's 500 Stock Composite Index (S&P 500)  
 P = Price on the S&P 500  
 RF = Risk factor, which is computed to allow for the best performance of our model  
 CBY = Corporate bond yields on the Salomon Brothers' long-term, high-grade corporate bond index  
 IE = inflation expectations, which are given for any year X by the inflation rate (CPI-U) in the preceding year X-1  
 SS = switch signal

The logic of the model is quite straightforward. When stocks are cheap relative to bonds, risk-adjusted real yields on stocks ( $E/P - RF$ ) exceed real yields on bonds ( $CBY - IE$ ). Hence, the switch signal (SS) is positive. With this positive signal, investors should switch their portfolios to 100% stocks. Alternatively, when the switch signal is negative, bonds are cheap relative to stocks, and investors should switch their portfolios to 100% bonds. Hence, our model signals investors to be either 100% in stocks or 100% in bonds.

So much for our model's logic. Let's consider a few of the model's details. Stock returns — earnings yields ( $E/P$ ) on stocks — are intrinsically more risky than high-quality corporate bonds. That fact can be verified by noting that the standard deviations (variability) of average returns for "All Stocks" exceed the standard deviations for "All Bonds" (see Chart 13). In consequence, to put earnings yields on a risk-adjusted basis so that they are comparable to bond yields, we subtract a risk factor (RF) from the earnings yield on stocks. We compute the risk factor to allow for the best switch model performance.

It is important to mention that the risk-adjusted yield on stocks is a real (inflation apart) yield because both earnings on stocks and stock prices fluctuate with changes in inflation. Hence, the ratio  $E/P$  represents a real earnings yield on stocks.

Corporate bond yields (CBY) are given in nominal terms. Hence, to make bonds comparable to stocks, we must transform nominal bond yields to real bond yields. This is done by subtracting inflation expectations (IE) from nominal bond yields (CBY).

\* \* \* \* \*

To test the model, we employ quarterly data from 1929:4 through 1989:4. Chart 13 contains a summary of our results. The "All Bonds" column indicates average returns and standard deviations if investors are exclusively in bonds. The "All Stocks" column indicates those same data if investors are exclusively in stocks. The "Switch Model" column indicates average returns and standard deviations if investors would have invested in accordance with the quarterly signals given by our model. The last column ("All-Knowing Best Model") indicates the returns and standard deviations if investors would have had perfect foresight, would have been able to invest perfectly in either 100% stocks or 100% bonds, depending on which alternative actually yielded the highest returns in each quarter. Hence, "All Knowing" column represents performance of the hypothetical perfect investor.

Investors who would have employed our "Switch Model" would have outperformed those who followed a buy and hold strategy for either stocks or bonds. For example, if an investor would have invested \$100 in 1930:1, it would have grown to \$103,264, \$26,502 and \$2,077, depending on whether an investor had employed the "Switch Model", stayed exclusively in stocks or stayed exclusively in bonds, respectively. In addition to enhancing returns, the switch strategy would have reduced the variability of portfolio returns. Hence, it would have reduced risks.

The "Switch Model" is not, of course, perfect. This can be seen by comparing the "Switch Model" and "All Knowing" columns in Chart 13. Chart 14 presents more detailed data on the performance of the "Switch Model." The first two columns show the number of quarters in each decade that the "Switch Model" signaled to be in either bonds or stocks. The last three columns show the number and type of wrong signals in each decade. In the 1980s, for example, the "Switch Model" indicated that investors should be invested in bonds 17 quarters and stocks 23 quarters. In 20 of the 40 quarters in the 1980s, the signals were incorrect. In 11 quarters the "Switch Model" signaled stocks, when investors should have been invested in bonds, and in nine quarters, the model signaled bonds, when investors should have been invested in stocks.

**IMPLICATIONS:** *The "Switch Model" indicates that for 1990:1 and 1990:2, investors should have been invested in bonds. Bonds were cheap relative to stocks. In 1990:3, the current quarter, investors should be invested in stocks because they are cheap relative to bonds.*

— Dr. Steve H. Hanke

**Chart 13**  
Alternative Portfolio Strategies

Period	All Bonds	All Stocks	Switch Model	All-Knowing Best Model
	Avg.Ret./S.D.	Avg.Ret./S.D.	Avg.Ret./S.D.	Avg.Ret./S.D.
1930s	6.9%/2.6%	9.9%/24.6%	13.6%/11.0%	40.9%/19.4%
1940s	2.7%/1.0%	10.1%/ 7.7%	10.1%/ 7.7%	18.3%/ 4.7%
1950s	1.1%/2.6%	18.7%/ 5.8%	18.6%/ 5.8%	23.2%/ 4.5%
1960s	1.8%/2.6%	8.5%/ 6.5%	10.0%/ 5.4%	15.9%/ 4.1%
1970s	6.4%/4.1%	7.5%/ 9.1%	7.1%/ 9.1%	18.0%/ 6.1%
1980s	13.6%/7.7%	17.9%/ 8.3%	18.4%/ 6.2%	28.4%/ 7.3%
1930-1989	5.4%/4.2%	12.1%/12.3%	13.0%/ 7.7%	24.2%/ 9.6%

**Notes:**

1. "All Bonds" is a strategy that leaves the investor in bonds at all times.
2. "All Stocks" is a strategy that leaves the investor in stocks at all times.
3. "Switch Model" is a strategy that switches the investor from 100% stock to bonds 100% and vice-versa, according to the criteria described in text.
4. "All-Knowing" assumes the investor knows beforehand which investment (100% stocks or 100% bonds) would generate the highest yield in each quarter, and that the all-knowing investors placed funds in that option.
5. Average returns are arithmetic means for annualized returns.
6. "S.D." is the standard deviation of the average returns, and indicates the volatility of average returns.
7. All data from Ibbotson Associates, *Stocks, Bonds, Bills and Inflation*, Chicago: 1990.

**Chart 14**  
"Switch Model's" Performance

Period	Switch Signals (Quarters)		Wrong Signals		
	Bonds	Stocks	Total	Bonds <sup>1</sup>	Stocks <sup>2</sup>
1930s	19	21	13	8	5
1940s	0	40	16	16	—
1950s	1	39	10	9	1
1960s	2	38	12	11	1
1970s	1	39	21	20	1
1980s	17	23	20	11	9

**NOTES:** 1. Should have been invested in bonds. But signal indicated stocks.  
2. Should have been invested in stocks. But signal indicated bonds.

**CURRENCIES**

**Canadian dollar**

Last month we reasoned that the Bank of Canada was moving into a position of being able to lower interest rates as monetary aggregates, particularly M2, were moderating their rates of growth. We argued that "from past behavior, it would not be unreasonable to believe that a 100 basis point narrowing of the interest rates differential could initially produce a Canadian \$ drop of 2.5%-3.5%, perhaps the outer limit of the bank's tolerance range. As such, the easing will have to be pianissimo."

Because timing was so crucial (given the high cost of borrowing Canadian dollars), we deferred a sale recommendation until August 27 (see Hotline Update), when it became clear that a downtrend in interest rate differentials had emerged (see Chart 15). Our estimate of the impact on the exchange rate of a 100-basis-point narrowing proved remarkably conservative: The dollar has fallen 3.65% as the differential narrowed by 57 basis points.

Recent developments indicate that the Bank has precious little further room to ease. In the first place, by their own admission they "...would expect annual rates of increases (in M2 and M2+) that are consistently below 10%, and ultimately going down to well below 10%..." (speech given by John Crow, Governor of Bank of Canada, September 13).

Chart 16 shows that year-over-year percentage change in M2 stabilized at just under 10%. In recent weeks, M2 has shown a much faster rate of growth than evident over the first half of the year, an early warning that further easing may be imprudent. The Bank is particularly well aware of the link between inflationary expectations, a credible monetary policy, and interest rates. Secondly, the surprising victory of the socialist New Democratic Party in the provincial elections held last week in Ontario is certain to increase long-term

capital outflows from Canada, making it imperative for the Bank to maintain a high interest rate policy to avoid an eventual balance of payments crisis.

Finally, the Bank is well aware of the notorious inflationary impact of a weak dollar. As such it is unlikely to allow the dollar to depreciate much beyond 4% to 5% from the recent peak before committing first some of its large international reserves and then using again an interest rate policy (independent of a money supply target). In short, the Bank is likely to follow a "monetarist" policy between 84.50 and 88.50 and an "exchange rate" policy beyond these two levels.

**STRATEGY:** Retain short December '90 Canadian dollar, initiated August 27 at approximately 86.35 (see Hotline Update). There is still another 100-point to 150-point profit potential before the going gets rough.

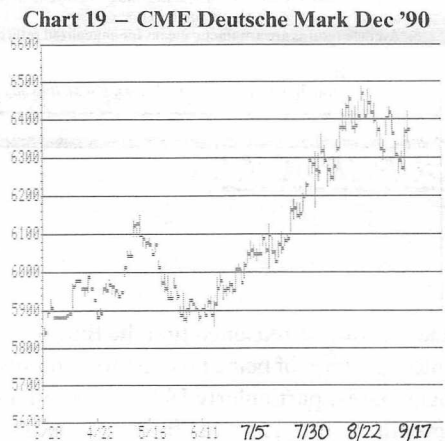
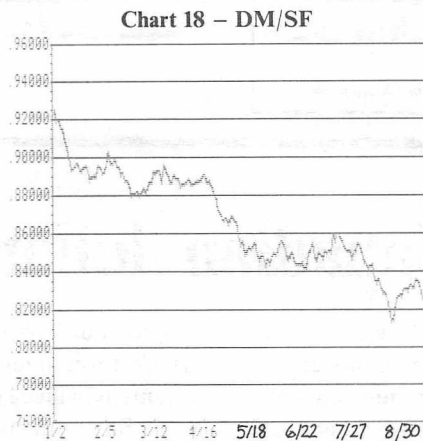
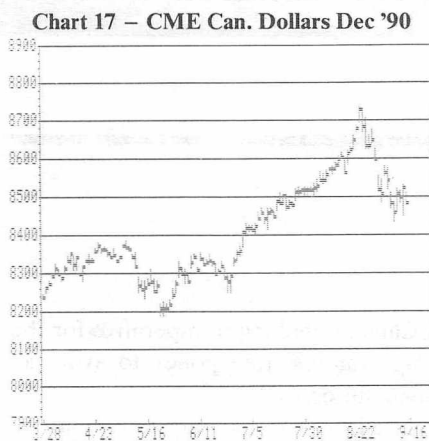
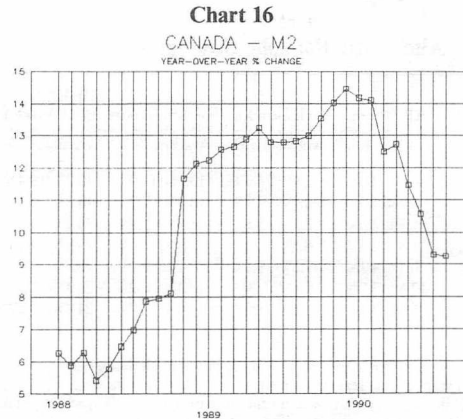
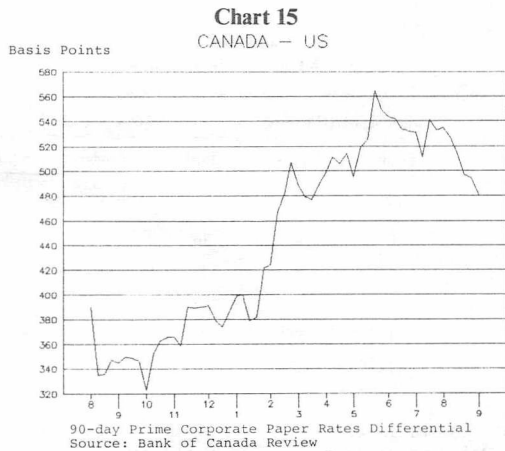
**Swiss francs**

Swiss franc/Deutschemark. Our patience paid off: The DM fell to 82 Swiss centimes, allowing us to close out a highly profitable long Swiss franc/short DM spread.

**Deutschemark**

We liquidated our outright long positions in DM and SF on Monday August 27 (see Hotline Update for August 24), accepting handsome profits.

On August 29 we initiated short positions in DM only, placing initial stops at 65.60, basis September '90, close only (see Hotline Update for August 29). Roll positions forward to December '90 and lower stops to 64.50, close only.



**CRUDE OIL**

**Selling on the news?**

Behind the extraordinary rise in crude prices is a story of inventory hoarding that bears little relation to the underlying supply/demand relationship. The numbers are telling: August Opec production was 19.7 million barrels per day (b/d), down from the *excessive* (remember the \$15/barrel crude in July?) 23 million b/d output in July, allowing bulging inventories to be drawn down by roughly 60 million barrels. This compares with an overhang, which in May we estimated at more than 400 million barrels (see our May 20, June 24, and July 22 issues). September Opec production will come in as high as 21.9 million b/d and October could hit 22 million b/d, close to "equilibrium" levels before the invasion of Kuwait.

But here is the catch. At these rarefied levels, consumption is unlikely to hold up. Every 1% drop in world demand, represents a "savings" of 600,000 b/d. Can anyone be sure that demand won't fall 1% to 5%? Furthermore, oil inventories are as high today as they were in the 1980-82 period (see Chart 20). Clearly, the day-to-day fundamentals do not justify a spot price of \$30+/barrel.

What is, then, behind the run-up? A fear, founded or

unfounded, but a fear nonetheless, that any large-scale military action could place over 10 million b/d of production capacity under threat. For as long as the fear exists, speculative positions in crude and products will be built up by merchants and users. A quick, military resolution to the conflict, on the other hand, will cause massive liquidation of these positions, toppling prices, once again, to the mid-teens.

We are of the opinion that there is no solution to the Gulf conflict other than a lightning-fast and devastating high-tech attack on Iraq. Such an attack could come at any time, although "expert" military opinion points to an October 15 to November 15 timetable.

The ideal selling opportunity would take place at the commencement of military action, placing one's faith in the ability of the Allied forces to strike rapidly and successfully. Lacking such faith, *one should wait until the outcome of the conflict becomes clear.*

**STRATEGY:** Short March '91 crude oil as of August 28. Cover short positions at market and wait to reinstate once military conflict commences.

# Crack spreads

Our June recommendation (see our June 24 issue, "High on crack") to buy deferred products versus the sale of crude proved a bonanza. Put on at approximately \$2.90 a barrel, we took par-

tial profits at \$4.25/barrel as recommended at that time and remain long the balance of the position, looking to liquidate in the \$7-\$9/barrel range (if you have not already done so).

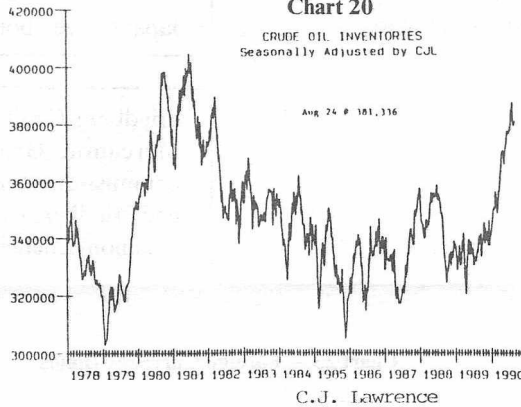
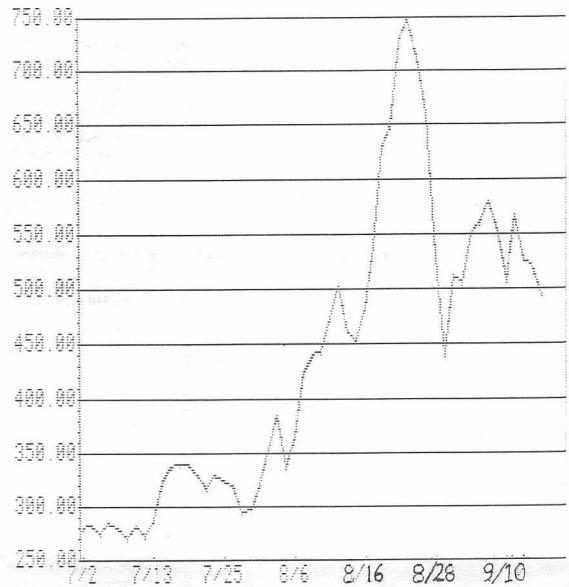


Chart 21 – NYME Crude Light Mar '91



Chart 22 – Crack Feb '91



## FRIEDBERG CAPITAL MARKETS

# Convertible bond update

### Pacific Scientific

For the second quarter, Pacific Scientific has reported that earnings were the highest in five years, rising to \$1.8 million, or \$0.30 per share, with six-month earnings at \$2.7 million, or \$0.45 per share. These profits represent a substantial improvement over last year, when second quarter earnings before an extraordinary gain from the repurchase of debentures stood at \$0.05 per share and six-month earnings before extraordinary gain were \$0.11 per share.

The good news continues with second quarter revenue

growth of 12%, to \$46.9 million. Six-month revenues were \$91.7 million, versus the previous year's \$84.3 million.

The higher earnings were attributable to improved operational efficiencies, as well as the growth in sales and margins. The results for the second quarter include two unusual items: the sale of the Sigma Division's relay product line, and a recall of a Sigma product to provide additional safety features. The recall diminished earnings by \$0.06 per share, while the sale of the relay product line added \$0.11 per share to the quarter's earnings. Recent stock price: \$11 1/8 per share.

**Sunrise Medical**

Sunrise Medical Inc., our star performer in the convertible department, continues to exhibit strength. Recently released fourth quarter results put earnings at \$0.47 per share versus \$0.36 for the same period last year. Net income rose 16.61% per annum, from a 1989 figure of \$40.9 million to the present 1990 figure of \$47.7 million. It's worth noting that this is the sixth consecutive quarter of record sales and earnings versus the previous year. Recent stock price: \$15 1/4 per share.

**Recommended bond portfolio allocation**

Swiss franc and/or DM denominated bonds	35%
US dollar high-yield convertible bonds	20%
Argentina Bonex	5%
British pound fixed-rate bonds	12.5%
Danish krone fixed-rate bonds	17.5%
Japanese yen bonds	10%

Friedberg Capital Markets is a division of Friedberg Mercantile Group, a securities dealer and futures commission merchant. Friedberg Mercantile Group and Friedberg Commodity Management Inc. are under common beneficial ownership, control and management.

**Chart 23 – Foreign Currency Bonds**

Date: September 13, 1990

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 DATE	NEXT PAY DATE
<b>CANADIAN DOLLAR DENOMINATED BONDS</b>					
GOVERNMENT OF CANADA (semi annual) 05/12/90 10 1/4%	99.55	- 99.85	10.67	05/06/90	05/12/90
<b>NEW ZEALAND DOLLAR DENOMINATED BONDS</b>					
CAN. IMP. BANK OF COMMERCE 27/07/92 14% RISP eligible	101	- 101 3/4	12.81%	27/07/90	-27/07/91
<b>AUSTRALIAN DOLLAR DENOMINATED BONDS</b>					
General Electric 11/07/92 14 1/4% (semi)	101 1/2	- 102 1/4	13.19%	11/07/90	-11/01/91
COMMONWEALTH BANK OF AUSTRALIA 01/07/94 14%	100 5/8	-		01/07/90	-01/07/91
WORLD BANK 15/03/93 12 3/4% RISP eligible	100 5/8	- 101 3/8	11.99%	15/03/90	-15/03/91
CAN. IMP. BANK OF COMMERCE 13/03/91 13% RISP eligible	98 5/8	-		13/03/90	-13/03/91
<b>DANISH KRONE DENOMINATED BONDS</b>					
STOCKHOLM 10/11/91 10 5/8%	100	- 100 3/4	9.84%	10/11/90	-10/11/91
<b>BRITISH POUND DENOMINATED BONDS</b>					
KGM of SWEDEN 14/4/93 9 3/8%	91 7/8	- 92 7/8	12.74%	14/04/90	-14/04/91
<b>DEUTSCHE MARK DENOMINATED BONDS</b>					
QUEBEC HYDRO 5 1/2% 1/5/96 RISP eligible	85	- 85 3/4	8.81%	01/05/90	-01/05/91
PROVINCE OF QUEBEC 6% 1/4/97 RISP eligible	84 1/2	- 85 1/4	9.08%	01/04/90	-01/04/91
EUROPEAN INV. BANK 5 1/2% 9/8/93	91 3/4	- 92 1/2	8.53%	09/08/90	-09/08/91
BANK OF NOVA SCOTIA 5 5/8% 07/05/96 RISP eligible	84 3/4	- 85 1/2	9.01%	07/05/90	-07/05/91
WORLD BANK 5 7/8 4/2/97 RISP eligible	84 1/4	- 85	9.07%	04/02/90	-04/02/91
<b>SWISS FRANC DENOMINATED BONDS</b>					
GOVT. OF AUSTRALIA 30/10/98 5% JAPANESE YEN DENOMINATED BONDS	86	- 88	6.99%	30/10/89	-30/10/90
GOVT. OF CANADA 23/7/93 5 5/8% RISP eligible	93 1/2	- 94 1/4	7.95%	23/07/90	-23/07/91
<b>U.S. DOLLAR DENOMINATED FIXED CONVERTIBLE BONDS</b>					
PACIFIC SCIENTIFIC 7 3/4% 15/06/03(semi) CV @38 p/sh	71	- 73 1/2	12.17%	15/06/90	-15/12/90
SUNRISE MEDICAL INC. 7.25% 26/6/96 CV @517 5/8 p/sh	92	- 94 1/2	8.48%	26/06/90	-26/06/91
ALLIANT COMPUTER 7.25% 15/05/12(semi) CV @39.75 p/sh	41	- 43	18.24%	15/05/90	-15/11/90
COOPER CO'S. 10 5/8% 01/03/05(semi) CV @27.45 p/sh call in 1995 @100	70 1/2	- 72 5/8	15.99%	01/03/90	-01/03/91
DICEON ELECTRONICS 5.5% 1/3/12 (semi) CV @39.50 p/sh	32 1/2	- 33 1/2	18.16%	01/09/90	-01/03/91
<b>U.S. DOLLAR DENOMINATED FIXED RATE BONDS</b>					
ALBERTA 7 3/8% 9/12/91 RISP eligible	98 3/4	- 99 1/2	7.78%	09/12/89	-09/12/90
<b>U.S. DOLLAR DENOMINATED FLOATING RATE NOTES</b>					
UNITED KINGDOM 24/9/96 3 mo. LIBID-1/8 (qly)	99.70	- 100	8 1/4%	28/06/90	-28/09/90
REPUBLIC OF ITALY 30/4/93 3 mo. Libson(qly)	99.30	- 99.70	8 1/16%	31/07/90	-31/10/90

Although we monitor these issues specifically, we also can fill any order in any foreign currency bond.

For further information and current prices please call:  
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**Chart 24**  
**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. Rates as of September 13, 1990.

	U.S. \$	NEW ZEALAND \$	AUSTRALIAN \$	DEUTSCHEMARK	SWISS FRANC	JAPANESE YEN	DANISH KRONE	BRITISH POUND
2 year	7.98%	CIBC 14% 11/7/92, yields 12.81% (.597 NZ/US)	General Electric 14¼% 11/7/92 yields 13.19% (.782 A/US)					
3 year	8.17%			EIB 5½% 9/8/93 8.53% (1.60 US/DM)		Canada 5% 23/7/93, yields 7.95% (137.06 US/JY)		Sweden 9¾% 14/4/93, yields 12.74% (1.647 BP/US)
6 year	8.55%							
7 year	8.69%			Prov. Queb. 6% 1/4/97 yields 9.08% 1.626 US/DM				
8 year	8.72%				Australia 5% 30/10/98, yields 6.99% (1.164 US/SF)			
Spot Exchange Rate	N/A	.6241	.8198	1.586	1.3235	137.9	6.073	1.865

\*For example, since a US\$-based investor would receive 483 basis points (1281-798) by holding the CIBC NZ\$ bond, the NZ\$ can depreciate to .597 NZ/US from the present spot exchange rate of

.6241 NZ/US over the next 2 years for the NZ\$ investment to break even with current US\$ rates of interest. Assumes that bonds are held to maturity, and coupons are reinvested.

## THE EXOTICS

### Swedish krona

Sweden is beset by an inflation rate of 11.1% year on year through August 1990, one of the highest in Western Europe, and a current account deficit in 1990 approaching 5% of GDP. These economic evils are a direct consequence of the extremely permissive monetary policy put into practice by the Central Bank which allowed domestic credit to expand by 95% in the 1986 through 1989 period.

Even though interest rates were raised in February to almost 15% (basis three-month Treasury discount notes), they have more recently been allowed to fall back to the 12.5% range (even though long-term rates have remained

close to 14%), showing once again the Central Bank's lack of firm determination to bring credit and money aggregates under control.

The foreign exchange markets correctly perceive this irresolution and justifiably fear a devaluation, the fifth one since 1977. Given the upcoming election, it is quite possible that the Swedish government will take the easy way out and devalue.

**STRATEGY:** Sell six-month forward Swedish kroner against DM or preferably against a high yield EMS currency such as the Italian lire. Remain neutral against the US dollar.

Chart 25

YEAR	SWEDISH KRONOR PER U.S. DOLLAR (Period )	=====BASKET=====			
		U.S. 1970 = 1.00	U.S. 1978 = 1.00	1970 = 1.00	1978 = 1.00
1967	5.1621	0.9577	1.2947	1.0138	1.0615
1968	5.1682	0.9805	1.3256	0.9732	1.0190
1969	5.1701	1.0076	1.3622	0.9945	1.0413
1970	5.1862	1.0000	1.3520	1.0000	1.0471
1971	5.1081	0.9552	1.2914	0.9967	1.0437
1972	4.7624	0.8706	1.1770	0.9617	1.0070
1973	4.3673	0.7932	1.0723	0.9304	0.9742
1974	4.4394	0.8136	1.1000	0.9518	0.9967
1975	4.1522	0.7571	0.9235	0.9269	0.9706
1976	4.3559	0.7625	1.0309	0.8815	0.9231
1977	4.4816	0.7494	1.0131	0.8988	0.9412
1978	4.5185	0.7397	1.0000	0.9550	1.0000
1979	4.2871	0.7283	0.9846	0.9986	1.0457
1980	4.2296	0.7169	0.9692	1.0258	1.0741
1981	5.0634	0.8452	1.1426	1.0625	1.1125
1982	6.2926	1.0246	1.3852	1.1855	1.2414
1983	7.6671	1.1848	1.6018	1.2718	1.3317
1984	8.2718	1.2345	1.6690	1.2161	1.2734
1985	8.6039	1.2373	1.6728	1.2139	1.2711
1986	7.1236	1.0018	1.3544	1.1282	1.1813
1987	6.3404	0.8875	1.1998	1.1025	1.1544
1988	6.1272	0.8428	1.1394	1.0941	1.1457
1989	6.4469	0.8733	1.1807	1.0774	1.1282
1990 (1Q)	6.1504	0.8035	1.0862	1.0290	1.0775

Above 1.00 = Undervalued    Below 1.00 = Overvalued

Chart 26

Year	Foreign Assets (Min US\$)	CURRENT ACCOUNT As % of GNP %	CUMULATIVE 12 QTR. Current Account (Min US\$)
1970	916	-0.8	-578
1971	1286	0.9	-110
1972	1950	1.3	654
1973	3267	2.7	2348
1974	3261	-0.9	1444
1975	4072	-0.4	535
1976	3553	-2.1	-2542
1977	3553	-2.6	-4171
1978	3263	-0.2	-4080
1979	369	-2.2	-4846
1980	-1221	-3.5	-7069
1981	-3119	-2.5	-9665
1982	-3748	-3.5	-10691
1983	-3629	-1.1	-7321
1984	-5107	0.2	-4228
1985	-3806	-1.6	-2396
1986	-6236	0.1	-1300
1987	-10559	-1.8	-2793
1988	-20578	-2.1	-3734
1989	-24374	-4.8	-8796

Chart 27

HARD CURRENCY COVER ( In millions of U.S. Dollars)

Reserves \* + Previous 12-months curren Account \*\*\*= 2723

(Reserves + 12-months C/A)/ Broad Money \*\* = 93.740/2732 = 3%

\*As at May 1990    \*\* June 1990    \*\*\* 1991 Estimated

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Figures in millions of U.S. Dollars

	Broad Money (Converted to U.S. Dollars)
1980 - Dec. 1570	69.28
1990 Jun 3107	93.740
% Increase (decrease)	98%    35.3%

Source: IFS

Chart 28 - Rates

Spot	1 Month	3 Month	6 Month	12 Month
5.7460 -	5.7577 -	5.8140 -	5.8940 -	6.0535 -
5.7540	5.7677	5.8245	5.9080	6.0715

**FOREX RATES & UPDATE**

<u>Currency</u>	<u>Spot</u>	<u>3-Month</u>	<u>12-Month</u>	<u>Comments vis à vis US\$</u>	<u>Comments vis à vis DM (Spot DM: 157.00)</u>
*Australian dollar	.8270-.8280	.8165-.8180	.7885-.7915	Neutral	Neutral
**Belgian franc	32.22-32.27	32.25-32.38	32.52-32.77	Neutral	Neutral
**Danish krone	5.9800-5.9880	6.0175-6.0305	6.1250-6.1430	Neutral	Neutral
**Dutch guilder	1.7670-1.7680	1.7686-1.7699	1.7785-1.7805	Neutral	Neutral
Greek drachma	151.50-152.50	154.60-159.50	164.50-179.50	Neutral	Neutral
Hong Kong dollar	7.7640-7.7650	7.7660-7.7680	7.7925-7.7915	Neutral	Neutral
**Irish punt	1.7170-1.7185	1.7050-1.7080	1.6640-1.6680	Neutral	Neutral
**Italian lira	1170-1171	1176-1178	1208-1212	Neutral	Neutral
Kuwaiti dinar	Good luck			—	—
Malaysian ringgit	2.6950-2.6960	2.6960-2.6990	2.7000-2.7100	Neutral	Neutral
New Zealand dollar	.6265-.6275	.6160-.6180	.5890-.5920	Neutral	Neutral
**Norwegian krone	6.0480-6.0580	6.0835-6.0965	6.2045-6.2245	Neutral	Neutral
Portugese escudo	137.80-137.90	139.80-140.50	147.50-149.00	Neutral	Neutral
Saudi Arabian riyal	3.7495-3.7505	3.7510-3.7545	3.7540-3.7600	Remain short	Remain short
Singapore dollar	1.7715-1.7725	1.7690-1.7710	1.7625-1.7710	Neutral	Neutral
Spanish peseta	98.40-98.50	99.96-100.14	104.60-104.90	Neutral	Neutral

**Explanatory Notes**

\*Liquidated as per Hotline Update of August 27.

\*\*Liquidated as per Hotline Update of September 7.

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**

**Tuesday, July 24:**

No changes or new recommendations.

**Friday, July 27:**

No changes or new recommendations.

**Tuesday, July 31:**

No change or new recommendations.

**Friday, August 3:**

For new subscribers: As usual, there will be no market letter in August. This was inadvertently not mentioned in the last publication. Otherwise, no changes or new recommendations.

**Tuesday, August 7:**

No changes or new recommendations.

**Flash update, Thursday, August 9, 11:45 a.m.:**

Based on the hunch that desperate men will do desperate things and that it is therefore increasingly likely that Iraq will strike out at Saudi installations or population centers in order to gain leverage, we recommend the following: Buy October crude oil and sell February or March crude oil as a spread at present levels. Keep in close contact.

**Friday, August 10:**

Repeat as per Thursday's flash update. No other changes.

**Tuesday, August 14:**

No changes or new recommendations.

**Flash update, Wednesday, August 15, 10:30 a.m.:**

On Friday August 10, we advised you to put on spreads long October, short March crude oil on the assumption that a sudden desperate attack by the Iraqis on Saudi installations would spike nearby positions. Thus the spread would widen. Such an eventual-ity is now receding. Therefore liquidate this spread.

**Friday, August 17:**

As per our flash update Wednesday August 15, we liquidated our crude oil spreads — long October and short March. No other changes or recommendations.

**Tuesday, August 21:**

No changes or new recommendations.

**Friday, August 24:**

Two new recommendations:

1. Liquidate at market all outright long positions in SF and DM at the opening on Monday.
2. Liquidate at market all spreads long SF short JY at the opening on Monday.

**Flash update, Monday, August 27, 1:15 p.m.:**

Sell December C\$ at market initiating new short positions. Place initial stops at 8875, close only.

**Tuesday, August 28:**

As per our Hotline Update on Friday, we recommended liquidating long positions in SF and DM at the opening on Monday. As well, we recommended liquidating long SF short JY spreads.

As per our flash update of Monday the 27th, we sold December C\$ at around 8635 with stops at 8875, close only. New recommendations:

1. Holders of S&P put options should liquidate now. However, short positions in KC Value Line should be maintained.

2. Liquidate all long positions in EMS and other European currencies *vis à vis* the dollar.
3. Sell March crude oil and deferred months only, establishing new short positions. Place initial stops at 29.00, basis March, close only.

**Flash update, Wednesday, August 29, 9:25 a.m.:**

Followed by a recap of Tuesday's hotline update. Sell September DM at market, initiating a new short position. Place initial stops at 6560, close only.

As per our Hotline Update on Friday, we recommended liquidating long positions in SF and DM at the opening on Monday. As well, we recommended liquidating long SF short JY spreads.

As per our flash update of Monday the 27th, we sold December C\$ at around 8635 with stops at 8875, close only. New recommendations:

1. Holders of S&P put options should liquidate now. However, short positions in KC Value Line should be maintained.
2. Liquidate all long positions in EMS and other European currencies *vis à vis* the dollar.
3. Sell March crude oil and deferred months only, establishing new short positions. Place initial stops at 29.00, basis March, close only.

**Friday, August 31:**

A recap of the week's activities. As per our Hotline Update of Friday, August 24, we recommended liquidating long SF and DM positions. We also recommended liquidating long SF and short JY spreads.

As per our flash update of Monday the 27th, we sold December C\$ at around 8635 with stops at 8875, close only. Three new recommendations on our Tuesday update:

1. We liquidated long S&P put options. However, short positions in KC Value Line should be maintained.
2. We recommended liquidating all long positions in EMS and other European currencies *vis à vis* the US\$.
3. We sold March crude oil and deferred months only, establishing new short positions initial stops at 2900, basis March, close only.

**Friday, September 7:**

One new recommendation: Sell long Australian dollar position, accepting profits.

**Tuesday, September 11:**

No changes or new recommendations.

**Friday, September 14:**

A recap since our last market letter July 22. New positions:

1. Short December C\$ at approximately 8635 with stops at 8875, close only, as per our flash Monday, August 27.
2. Short March crude oil and deferred months with stops at 2900, close only, as per our recommendation Tuesday, August 28.
3. Short DM at approximately 6434, basis September with stops at 6560, close only, as per our flash update Wednesday, August 29.

**Positions still outstanding:**

- long T-bond put options
  - short Nikkei Dow futures
  - long crack spreads (having taken profits on half of position)
  - short yen bond futures
  - short KC Value Line futures
- Rolling forward to nearest month (December) when necessary.

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