

FRIEDBERG'S

COMMODITY & CURRENCY COMMENTS

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The worst is yet to come

When George Bush took office in January 1989, the US economy was well into its seventh consecutive year of a peacetime expansion. Indeed, it was growing at a 3.6% real rate, and our supply-side spread indicator was a healthy 3.8%. Since then, the economy has steadily deteriorated. At present, real growth is virtually nil and the supply-side spread is slightly negative. If this weren't enough, the oil shock, if it continues to hold crude prices at the \$35-\$40 per barrel level, will cut, after a year, about 1.5% off whatever your estimate for real growth was before the events in the Gulf.

So much for the good news. Let's take a look at the darker side of the economy, one that unfortunately has distinct possibility of being played out. To appreciate this darker side, we must begin by emphasizing that expansions usually don't die of old age; rather, they are killed by bad economic policies. On the economic policy front, the Bush Administration is an unmitigated disaster. The worst consequences of the Administration's policies are yet to come.

We begin our support of this rather harsh conclusion with some observations about the federal budget spectacle. When the President uttered the "T"-word (taxes), he gave up the moral high ground in Washington, D.C. Since then, he has been sliding down a steep, slippery slope into the pit of unpopularity. In pursuit of an "inside the beltway" deal, President Bush can't even get the facts straight, let alone make a coherent economic argument. For example, he has allowed the budget deal crowd to run free with their rich-bashing rhetoric.

The Bush Administration has not raised a glove against those in Congress who have screamed that President Reagan's tax reform of 1986 has kept the rich from paying their fair share of taxes. Indeed, we have been told that the income tax system is not progressive enough. So much for supply-side economics. We are now focusing on fairness, whatever that might mean.

At the prodding of our friend Mr. Warren T. Brookes, the Internal Revenue Service has released the most recent data (1988) on income tax revenue by income class. Chart 1 tells the whole story. Our tax system is very progressive, and the rich are already being soaked. For example, in 1988, the first year that the tax reform of 1986 was in full force, income tax revenue grew from 1987 by about \$47 billion. Incredibly, \$19.4 billion of the total increase, or 41.3% was, paid by the 65,303 taxpayers (6/100 of 1 percent of the total) who had income of \$1 million or greater. Another 35.5% of the in-

crease, or \$16.7 billion, was paid by 2.2% of the taxpayers who earned between \$100,000 and \$1 million. Hence, total income tax revenues increased by about \$47 billion, and \$36 billion of that amount was paid by those making over \$100,000. In other words, 2.3% of the taxpayers were responsible for 77% of the total increase in tax revenues from 1987 to 1988.

In the interest of cutting a budget deal, the Bush Administration has allowed these facts about the unbelievable progressivity of the current tax system to remain an "inside the beltway" secret. That is cowardly and irresponsible.

Another well kept secret is the fact that the Bush Administration is re-regulating the economy. The cutting edge of the Administration's re-regulation policies are the environmentalists in that Administration. For example, the President will sign the 1990 Clean Air Act. This action will be taken, even though the President knows that the price tag for that Act will be in the \$40 to \$70 billion range. Stacked against these costs are insignificant, if not questionable, benefits. For example, the cancer risks for 90-170 people will be reduced, and within 50 years, 75 lakes, with an average surface area of ten acres each (750 acres in total), will be de-acidified. Knowing this benefit-cost ratio, we must conclude that the President is driven by special interest politics, not sound principles that result in policies that serve the nation.

If the environmental re-regulators in the Bush Administration weren't enough, our White House contacts inform us that Dr. Greenspan has virtually no chance of being reap-

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

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pointed as Chairman of the Federal Reserve Board. The White House prefers a soft-money chairman. At the top of their list is Professor Martin Feldstein, one on the nation's greatest dollar bashers. Indeed, on Oct. 16, the Professor, in comments to an investment conference sponsored by the American Stock Exchange, was apparently campaigning for the top spot at the Fed. He stated that the collapse of the dollar since last spring represented an "orderly realignment" of major currencies. Professor Feldstein went on to say that an additional 10% to 15% decline in the real trade-weighted value of the dollar is warranted, and that it would be unwise for the Fed to pursue a monetary policy that would stem the dollar's fall.

Implications: We are perilously close to a recession. As this economic state becomes more evident, the Bush Administration's credibility will be seriously questioned. When this occurs, it will become clear that the Administration's attitudes about budget policy, regulation, and monetary policy are completely misguided. A crisis of confidence will ensue. Contrary to most economists, we can't stress the importance of that eventuality enough. Interestingly, John Maynard Keynes is the only major economist who shares our concerns about confidence. In *The General Theory of Employment, Interest and Money*, Keynes stated that:

"The 'state of confidence' as they term it, is a matter to which practical men always pay the closest and most anxious attention. But economists have not analysed it carefully and have been content, as a rule, to discuss it in general terms. In particular it has not been made clear that its relevance to economic problems comes in through its important influence on the schedule of the marginal efficiency of capital. There are now two separate factors affecting the rate of investment; namely, the schedule of the marginal efficiency of capital and the state of confidence. The state of confidence is relevant because it is one of the major factors determining the former, which is the same thing as the investment demand schedule."

In other words, Keynes said that when confidence wanes, investment will collapse. In consequence, the economy will falter further, stock markets will accelerate their declines, and the nation's currency will disappear from the standard radar screens. If confidence in the Bush Administration disappears, something that is shaping up as a real possibility, the worst will be yet to come. Moreover, it will be worse than the bears anticipate.

— Dr. Steve H. Hanke

Chart 1
1987-1988 Income Tax Trends (millions of \$)

Income Class	Revenue Growth 1987-1988	% of Total Growth	% of Taxpayers	% of Total Burden
Under \$15,000	- 765	- 1.6%	43.0%	3.3%
15,000 - 50,000	2,611	5.6%	44.4%	33.8%
50,000 - 100,000	9,018	19.2%	10.4%	26.5%
100,000 - 1 million	16,661	35.5%	2.2%	25.9%
1 million and over	19,381	41.3%	0.06%	10.5%
Total	46,906	100.0%	100.0%	100.0%

Source: *IRS Statistics of Income: Spring, 1990* and Warren T. Brookes

STOCK INDEXES

The bad news bears

Short term: Markets sell on the rumor and cover on the news. **Longer term:** Much lower.

With the bulk of the Sept. 30 quarterly statements out of the way, the market sighed a breath of relief — and rallied dramatically from the recent bear market lows. For one thing, there will be no more bad news from *that* quarter for another three months; for another, the Gulf crisis had become relegated to the inside pages of our newspapers, and while the build-up continued, war was no longer palpable or even certain.

The extent and magnitude of bear market rallies is a direct function of the degree of hope still latent in investors' hearts. The persistent relative strength of large-capitalization stocks (see Chart 2) tells us that institutional investors have not lost

hope. Therefore, rallies could be substantial. Our guess: a minimum of 9% and a maximum of 18% off the recent lows.

Longer term, the bear market has some distance to cover. Since earnings and dividends are the lifeblood of equity valuation, it behooves us to concentrate our analysis merely on prospects for these while ignoring, at least temporarily, other problems, such as the budget, Gulf war, etc.

Recession

By some yardstick, such as help-wanted advertising and corporate profit, the US is already in a recession. The 9% drop in cash flow between the fourth quarter of 1988 and the second quarter of 1990 is rapidly approaching the 12.8% peak-to-trough decline of the last major recession, 1973-1975. It is still

too early to compile third quarter overall results, but the betting is that the onslaught continues.

As *Industry Forecast*, published by David A. Levy and S. Jay Levy, put it: "The 1990-1991 recession is unlike any other of the postwar era in salient ways:

"1. The 1990 slump is a capital goods recession; it is not an "inventory recession" caused by speculation in goods. Such speculation was discouraged during the past few years because goods inflation was mild and inventory carrying costs, especially interest rates, were high. Moreover, business has not been concerned about shortages. Rather, this recession has been caused by the excessive construction of offices, hotels, stores, and condominiums that has led to high vacancy rates and a slide in outlays for new construction. Moreover, the slowing growth of consumer demand has been leading to a slackening in equipment investment.

"2. The financing of much of the excessive construction has left many financial institutions with large portfolios of nonperforming and about-to-be nonperforming loans. So far the major manifestation of this situation has been the savings and loan association disaster. But the recent newspaper accounts of the problems of large banks and insurance companies are ominously informing that we have seen but a small part of a developing financial debacle. The use of debt during the past decade to bid up the prices of existing assets is, in addition to excessive construction, at the heart of the current financial mess.

"3. Financial markets will be hit by collapses of many corporations that have been heavily financed by junk bonds. *Meanwhile, bank and insurance company holdings of ill-advised mortgages and junk bonds will cause waves of insolvencies. These disasters will have repercussions in securities markets.* No similar situation existed during any previous postwar recession."

There are, in addition, two troublesome developments. Past recessions came to an end via potent dosages of fiscal deficits. Consciously or unconsciously, the US government had taken a strong Keynesian anti-cyclical posture in both the 1973-1975 and the 1981-1983 recession.

Right now, the *cyclically adjusted budget deficit* is barely higher than it was in 1985 (\$180 billion vs. \$171.9) and below the 1986 deficit (\$185.4 billion). In relative terms, given the large increases in nominal GNP over the past five years, the cyclically adjusted budget deficit is inadequate to turn the economy around.

What is worse, a rising nominal budget deficit has set off alarm bells in Washington, where President Bush and Congress are locked in a battle to lop off \$500 billion from the cumulative prospective deficits of the next five years. Whether they will succeed or not is not as relevant as the mere fact that Washington has become fixated on a nominal variable (\$300 billion deficit) that is fast losing its significance. Any movement in the direction of raising taxes will clearly aid the pro-cyclical forces and extend the recession (see also "The worst is yet to come" on Page 1).

The second disquieting element in the main picture is

the developing weakness of foreign economies and its negative impact on US net exports. The August/September merchandise trade deficit average, at \$9.2 billion, stands approximately \$2.5 billion higher than the second quarter average, even while the rise in petroleum prices has been offset somewhat by lower imports. The slight 1.6% rise in August merchandise exports is running well below the second quarter, indicating a decline in real exports for the period, the first *back-to-back quarterly decline in real merchandise exports since 1985*. A synchronized world slump (see Chart 4 where it is apparent that virtually all major market economies are facing growth slowdown or recession) will make it all the more difficult for the US to recover, as it did out of the last two major recessions.

Corporate balance sheets

Two charts (Charts 5 and 6) are worth more than two thousand words. While cost-cutting measures are an important defensive response in a recession, helping to ward off defaults, they are not nearly as important as raising cash flow to repair overextended balance sheets. It took a 38%, 34%, and 80% surge, respectively, in cash flow, to move the debt-servicing ratios down following the 1969-70, 1981-82, and 1974-75 recessions. And sharp increases in cash flow can take place only during *vigorous* economic recoveries, a rather remote expectation.

Valuation

Since stock prices represent in simple terms the present value of a stream of futures earnings discounted by an appropriate interest rate, it follows that *real* price-level differences over periods of time can differ only if growth prospects change and/or interest rates change. Over *long* periods of time, therefore, *real* stock prices should oscillate around a value area. Although Chart 7 does not fully meet our expectations, it does tell us that stock prices are as expensive today as they were in the mid to late '60s, just before the great 1969-1974 bear market and clearly more dear than they were in the fateful year that ushered in the Great Depression.

Could it be that ever since the Depression, investors have taken into account an all-benevolent and all-omnipotent state and have thus adjusted downwards their risk premiums (lower interest rates = higher capitalization rates)? If they did, they may be in for a rude awakening. The state no longer has the resources or the political willingness to embark on a Great Bailout.

And while the S&P 400 may not plunge to the 60 to 80 level recorded during the despondent '30s and '40s, it could easily return to the mid-point of our chart. And that represents a 40% drop from 1989's *average level* (320) and a minimum drop of 56% from 1990's highs (437).

STRATEGY: *We advised purchasing S&P 500 futures to cover our short Value Line positions, anticipating a strong short-term rally (see Hotline Update of October 18). The ongoing rally will give us an excellent opportunity to re-establish short positions at higher levels. We'll keep you posted.*

Chart 2 - S&P Value Line

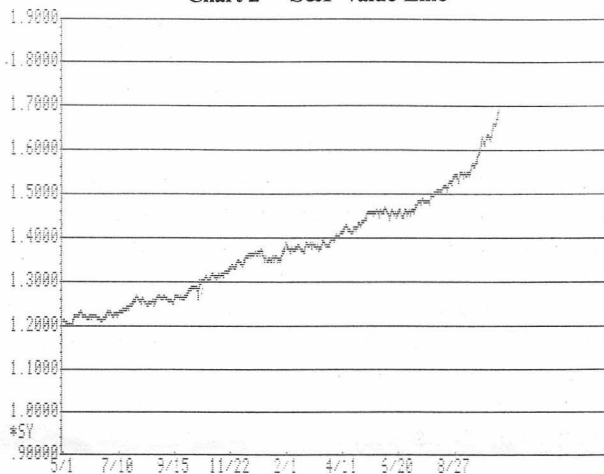


Chart 3 - Value Line Cash

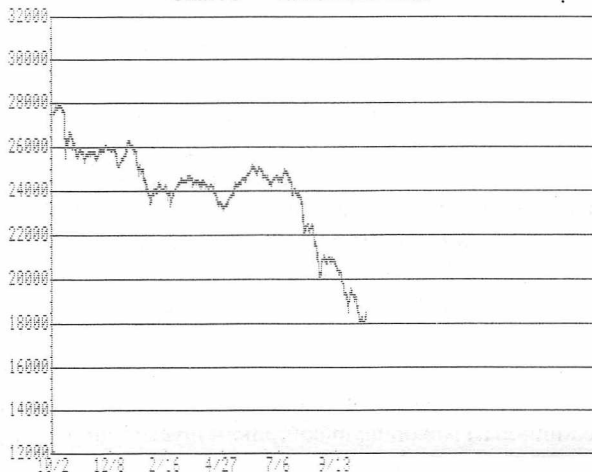
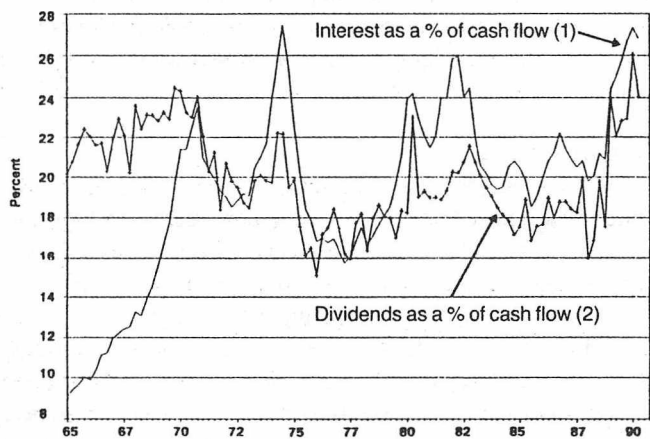


Chart 5
Payout Ratios: Nonfinancial Corporations
Dividends & Interest as % of Cash Flow

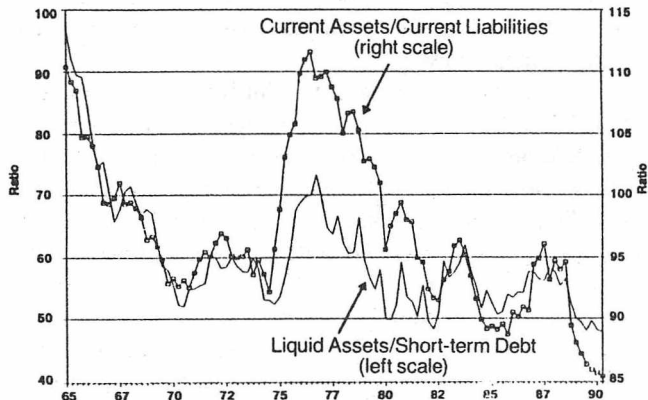


(1) Cash flow before interest but after dividend payments.
(2) Cash flow before dividends but after interest payments.

Source: *Financing and Market Perspectives*, Merrill Lynch

Chart 6

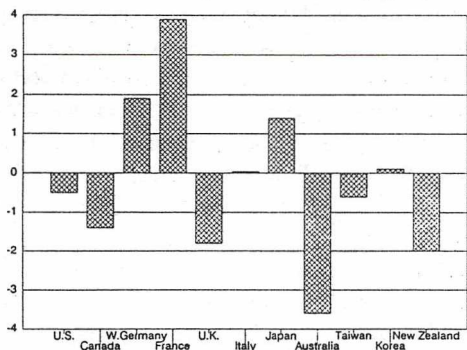
Current Ratios
Nonfinancial Corporations



Source: *Financing and Market Perspectives*, Merrill Lynch

Chart 4

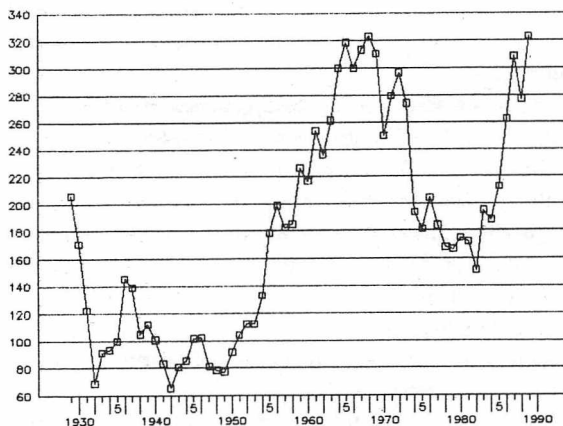
LATEST LEADING INDEXES, GROWTH RATES (%), 11 COUNTRIES



Note: Growth rates are six-month smoothed percent changes at annual rate.

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Chart 7 - Real S&P 400



S&P 400 deflated by GNP Implicit Price Deflator, in 1989 dollars.

CURRENCIES

US dollar

The extremely weak US economy coupled with the possibility that soft-currency proponents are gaining the upper hand at the Fed (see Dr. Steve Hanke's article on Page 1) augurs poorly for the US dollar.

STRATEGY: Long positions in all EMS currencies are advisable, although our favorite play remains the yen (see Japanese yen, below).

Chart 8 - CME Deutsche Mark Dec '90

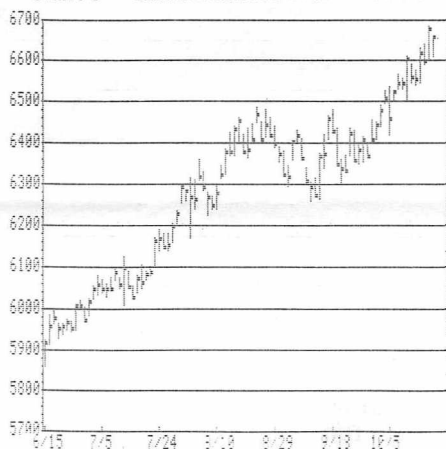


Chart 9 - CME Swiss Franc Dec '90

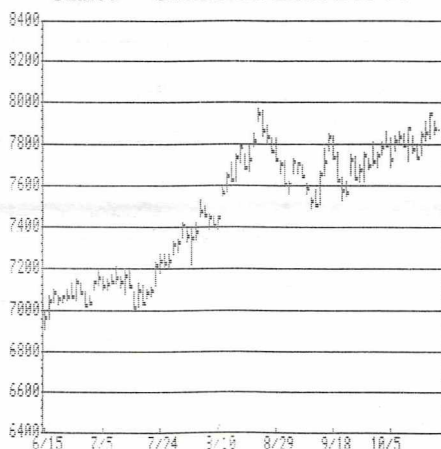
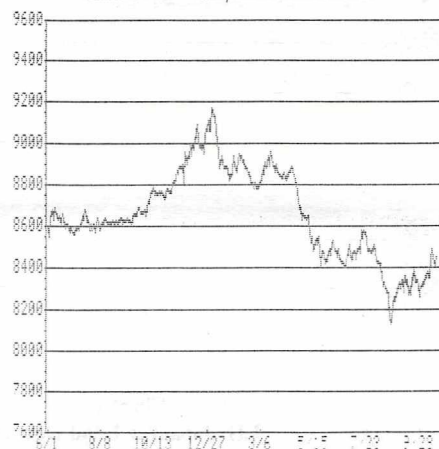


Chart 10 - SF/DM cross rate



Japanese yen

The nearly 50% collapse of stock prices prompted the Ministry of Finance to announce a number of propping-up measures that clearly did not meet with BOJ's approval. The lowering of margin requirements to 20% from 30% is a particularly ill-conceived move, as it channels more credit to an already overextended sector. Ultimately, no government can stop the inevitable adjustment to reality.

At the same time, the BOJ announced that money supply growth had reaccelerated in September: M2 plus CDs were growing at an annual 12% rate after consecutive declines in money growth in the previous three months. Despite the recent easing of long-term rates, the #119 had rallied to yield 7.79% from 8.69% as recently as three weeks ago, short-term rates remain perched in the 8 1/4% area and are likely to rise further given the BOJ's dissatisfaction with money supply growth.

Japan's trade surplus, now running at a monthly seasonally-adjusted \$5 billion, is likely to contract further in coming months as a result of high oil prices and ultimately (after the "favorable" effects of the J-curve have passed) the rapidly appreciating yen, now trading at 126 yen to the dollar. September's average exchange rate for exports was 142.6 yen to the dollar, only marginally stronger than the 145.15 rate a year earlier. More importantly, *relatively* robust economic growth and the ongoing liquidity squeeze are reversing Japan's traditional external flows: Japan is becoming a net importer of capital and a net importer of goods and services, a situation that will severely affect the export sector but which may become one of the few bright spots in the world economy.

How high will the Nikkei-Dow rally? The substantial fall

in yields at the long end of the market (around 90 basis points) coupled with the "psychological" intervention of the Ministry of Finance and the apparent reduction in tension in the Gulf can produce a retracement of as much as 50% of the most recent decline. This would put the Nikkei-Dow at a maximum of 26,200-26,600. Long term bonds, on the other hand, are unlikely to rise any further as fear of inflation begin to take center stage.

Labor market pressures are intensifying with the job offer/applications ratio at the highest level since 1974 and contract wages (wages excluding bonuses) rising at a 5% year-on-year rate. And, of course, higher oil prices have as yet to filter through the economy.

The yen is poised to continue its spectacular ascent. From a global cyclical perspective, as we already pointed out, the yen's appreciation is extremely convenient: Protectionist forces in Congress, facing rising joblessness back home, will push for a bilateral trade balance with Japan (the US deficit last month stood at \$4.31 billion). The same is probably true for the UK, Canada, and parts of Western Europe. As a result, the yen will have to become *extremely overvalued* before the devaluationists are satisfied.

STRATEGY:

- 1) Despite the possibility of a further rally in stock prices, to 26,200-26,600, basis the Nikkei-Dow, we remain steadfast bears. Stay short.
- 2) Retain short positions in the yen bond traded on the LIFFE.
- 3) Maintain long positions in December '90 yen futures; raise stops to 71.90, close only.

Chart 11
NIKKEI 225 Index Spot

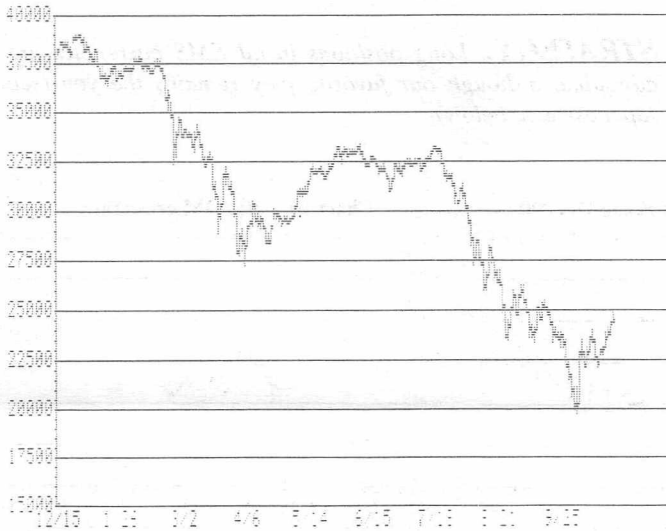


Chart 12
CME Japanese yen Dec '90

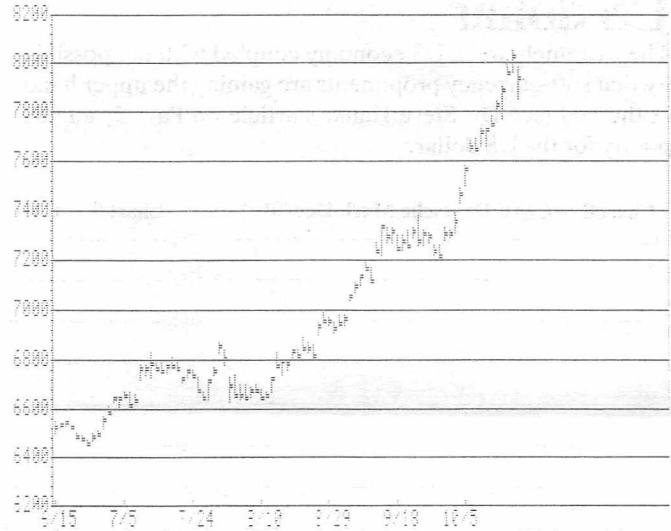


Chart 13
LIF Japanese Bond Dec '90

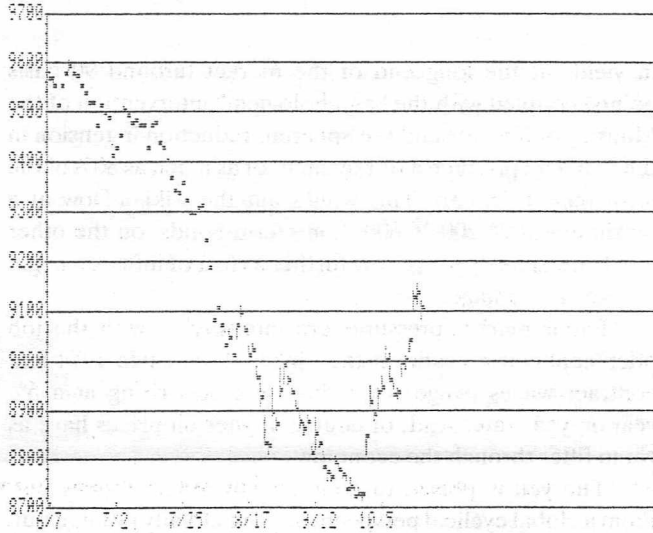
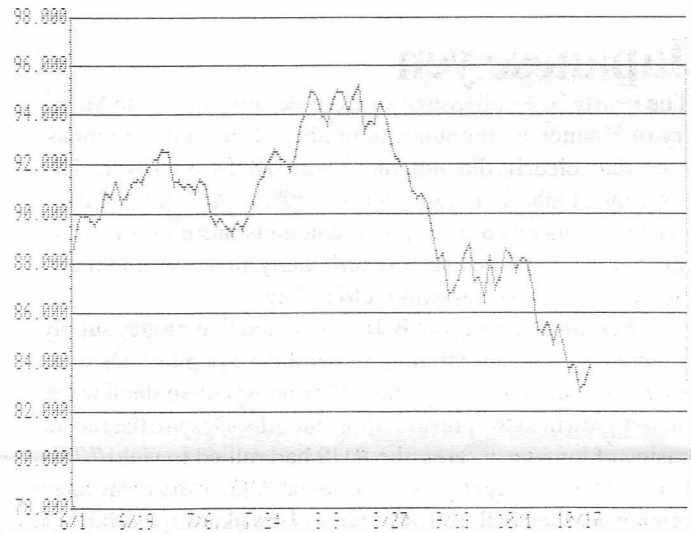


Chart 14
¥ per DM



Canadian dollar

The Bank of Canada, so says Bay Street, is toying with the idea of setting a 3% inflation target rate to be achieved by the end of 1992. This can be accomplished with a steady M2 rate of growth of about 8%. Guess what the year-on-year rate of growth of M2 is? Well, of course 8½%! (see Chart 15).

Despite this self-serving target rate (it would absolve the Bank from tightening further, although it may have to maintain present rates for a considerable period of time), the Bank would do well to target inflation. Inflation is much more practical and direct and much less esoteric than money-supply targeting; it will be up to the Bank to choose the means and methods for achieving its very measurable targets.

Last month we posited an 84.50-88.50 band for the Canadian dollar and simultaneously an M2 growth rate of 5%-6% per annum (compatible with 0%-2% inflation). Recent events reinforce our view of the allowable band (an 84.50 bottom). As a result, we advised covering profitable short positions and initiating new, long positions to take advantage of the deep forward discounts and the likelihood that the most recent easing exercise has come to an end.

STRATEGY: Long December '90 Canadian dollar as per Holine Update of October 18. Place initial stops at 84.00, close only.

Chart 15 - Canada - M2

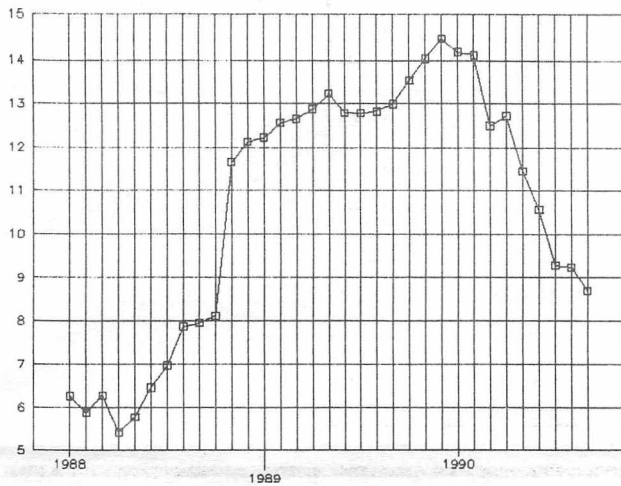
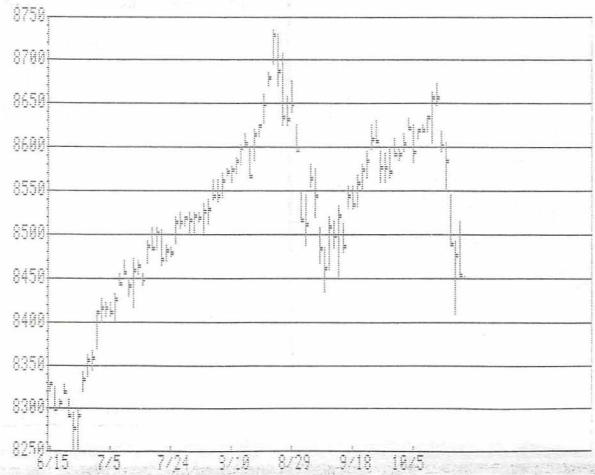


Chart 16 - CME Can. Dollars Dec '90



INTEREST RATES

The "Ted Spread"

One of our favorite themes of the past seven years has been the coming collapse of the US banking system (see articles entitled "The banking mess" in past issues). The Ted spread — the spread, in basis points, between equal maturity of Eurodollar deposits and T-bills — should have reflected this disintegration. Chart 17 shows that apart from sporadic bouts of panic, it hasn't. Why?

There are two reasons.

First, the authorities have all but enunciated, ever since Continental Bank (1984), that there are a number of banks "too-large-to-fail." These ten or eleven of the largest money center banks in the US are also the principal Euro-deposit takers. As a result, Eurodollar contracts, based on banks too-large-to-fail, should carry rates similar to US government-guaranteed paper. Secondly, the IMM poll (which leads to the final computation of the cash settlement price) taken from a number of randomly-selected bank traders asks them to estimate only what the *best Eurodollar deposit taker* would pay for a three-month deposit. The failure of one large bank would not affect the response, unless of course all Eurodollar deposit takers come under suspicion.

The situation has changed somewhat over the past few months. The Fed seems to be abandoning the "too-large-to-fail" philosophy: Recent staff papers (see, for instance The Federal Reserve Bank of Cleveland Working Paper 8805, "Lessons of the Past and Prospects for the Future in the Lender of Last Resort Theory," by Walker F. Todd) have concluded that it is counterproductive and that the Fed is best left to stabilize overall money supply growth. Markets have begun to believe that it is possible for a Chase Manhattan or Chemical Bank or Citicorp to fail; why else would their bonds trade to yield 11½% to 14%? And why should a non-

FDIC insured \$1 million Eurodollar deposit be much different than a bond issued by the parent bank-holding company? In other words, shouldn't wealthy clients of large money center US banks engage in arbitrage, i.e., redeem their Euro-deposits and purchase bank-holding company debt yielding 350 to 500 basis points more?

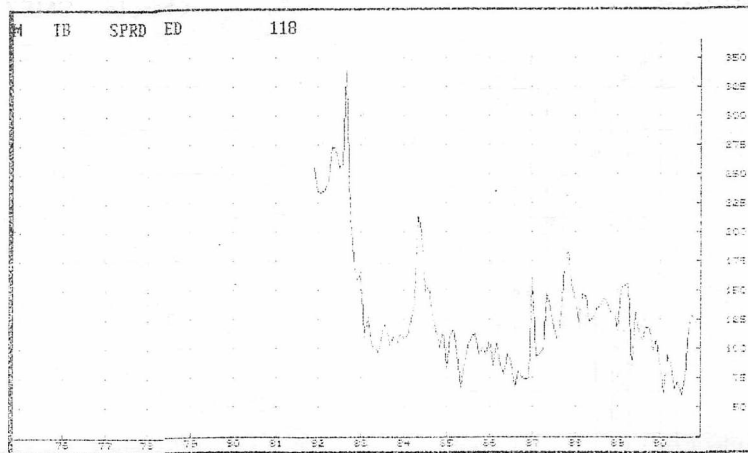
The second reason the Ted spread did not (or may not) reflect bank failures relates specifically to the *system* of polling traders and obtaining data leading to the cash settlement price. Here, too, a change is in the making.

The US banking system has become so sick that the failure of one large money center bank will immediately throw strong suspicion on at least four or five other ones. The consequent deposit run-off will put the stronger banks at a large disadvantage, forcing them to raise their rates as well. The upshot: a generalized rise in Eurodollar rates, although admittedly not as sharp as one would expect if the contract were based solely on the handful of potentially defaulting banks.

The trade is extremely attractive. Risk is 40 to 50 points (an improbable move back to the lows, see Chart 17), upside is a widening to 300 to 400 points, the level to which credit-worthy banks will be forced to bid to stave off a severe deposit run-off. (Will the Bank of England or the Swiss National Bank or the Bundesbank come to the rescue of their banks even in offshore localities? If yes, the virtual State guarantee may allow the European Eurodollar deposit takers to maintain deposits without being too aggressive; if no, spreads may well widen by much more.)

STRATEGY: On Sept. 26 (see Hotline Update), we recommended buying December '90 T-bills and selling December '90 Eurodollars as a spread.

Chart 17 – T-Bill – Euro Monthly Nearest Contracts



CRUDE OIL

Watch, wait, stand aside

We concluded last month that the better part of valor dictated entering the short side of the market only on commencement of military action. A tense, continuous stalemate could only push prices higher. Fear of an attack or fear of damage is always more powerful than the reality. Despite recent weakness, our judgment has been vindicated as deferred months, particularly March '91, stand \$1.50 to \$2/barrel higher on the month.

Iraqi feelers for a negotiated solution involving a partial withdrawal are not finding good reception in the US, Saudi Arabia, or in the UK, the main combatants. US objectives remain somewhat vague: Will an unconditional and full withdrawal of Iraqi forces suffice? The State Department seems to vacillate between a yes and a maybe.

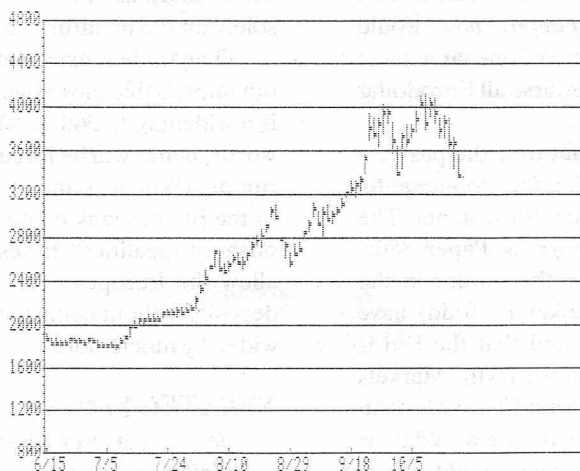
Others, particularly the UK, are less ambivalent: Nothing less than the downfall of Saddam Hussein and the dismantling of his military installations will suffice. Perhaps

the US is merely playing for time, waiting for the build-up and the training to be complete before it launches a pre-emptive strike. Or, perhaps, it believes that the embargo will do the job: This Saturday, the Iraqis rationed gasoline for fear of running out of normally imported chemical additives. Thus far, however, the embargo does not seem to have had a major impact on the population.

At any rate, an Allied attack does not appear to be as imminent as it did a few weeks ago. The US will be sending 500 new tanks from Germany, which will take three weeks to arrive at the Gulf, and Congressional elections are to be held in two weeks. The lack of a unified command at the Allied forces, however, may tempt Saddam Hussein to attack at any time, especially if the embargo is tightening the noose around his neck.

STRATEGY: *Be patient. The right moment to sell will be when hostilities break out.*

Chart 18 – NYME Crude Light Nov '90



LDC UPDATE

Argentina

Despite getting good marks for trying, President Menem of Argentina is beginning to run into a brick wall: a bewildering maze of regulations, a Kafkaesque bureaucracy, and an impatient, exhausted, and impoverished, population tired of waiting for long-term results.

Menem's privatizations, one of the few bright spots, has been running into daily problems. One day, a minister announces that the already privatized oil leases will be renegotiated because oil prices have skyrocketed and the buyers have reaped a windfall profit. The next day, Menem contradicts his Minister and reaffirms the sale.

The privatization of Entel, the telephone monopoly, was not completed when a consortium led by Manufacturers Hanover lost the award for one half of the company when it failed to come up with \$100 million cash payments and \$2.2 billion in equity debt paper.

Lack of confidence in the country's future has kept genuine investors at bay; only financial speculators are willing to play the privatization game with the result that a change in "market" conditions is likely to derail well meaning privatization efforts. The same can be said about the award of Aerolineas Argentinas' award to the Spanish Airline and its group of financial backers who infuriated the government when they disclosed that they would use a sale leaseback of airplanes to finance their purchase. Cronyism and financial engineering are the hallmarks of the privatization effort.

The government has moved to reduce the size of the state payroll with little success. Where it has managed to cut personnel and supplies, it has compounded the bureaucratic difficulties, for it has not deregulated sufficiently. A myriad of statutes and regulations remains on the books, but fewer people are left to administer them. Result: more delays, more payoffs, more illegal activities.

The savage increase in user tariffs and taxes produced a second-quarter fiscal budget surplus of \$729 million compared with a projected (in the stand-by agreement with the IMF) \$900 million surplus and a third-quarter surplus of \$375 million compared with a projected 1.2 billion dollars. The October surplus is likely to meet its target if only because of petroleum privatization proceeds. It is now apparent why the government has espoused so urgently the privatization route: It is a bankrupt state's only means of raising meaningful amounts of money. And it is also now clear why Menem cares so little about the transparency of the transactions. (All sorts of irregularities have been detected in a number of recent privatizations.)

A very tight monetary policy coupled with the illiquidity caused by the government's inability to pay its suppliers and the continuous preempting of credit markets by state-owned (bankrupt) enterprises have driven real interest rates in

australes to unsustainable levels. As a result the austral has been appreciating against the dollar in real terms by 10% to 15% per month. The grotesquely overvalued austral is damaging the export sector and is setting the groundwork for a future run on the central bank.

It is clear that the battle must be fought on the fiscal side. The government's inability to come to terms with its bloated public sector and maze of regulations — despite some good progress at the Central Bank in the area of monetary operations and policy — is rapidly imperiling the Menem program.

STRATEGY: *Given these uncertainties, we have decided to advise the sale of the Bonex 1982 series (see Hotline Update for October 3), which were originally purchased to yield 35% to 45% per annum. Present 20% yields do not justify the risk. Our total return, capital appreciation plus yield, exceeded 75% on purchases made in January of this year.*

Last Argentina update: April 22, 1990.

Recommended bond portfolio allocation

Swiss franc and/or DM denominated bonds	35%
US dollar high-yield and convertible bonds	25%
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 19
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 October 18, 1990.

	U.S. \$	NEW ZEALAND \$	AUSTRALIAN \$	DEUTSCHEMARK	SWISS FRANC	JAPANESE YEN	DANISH KRONE	BRITISH POUND
2 year	7.91%	CIBC 14% 27/9/92, yields 13.38% (.543 NZ/US)	General Electric 11/7/92 yields 12.77% (.674 A/US)				1 yr. US 7.50% Stockholm 10% 10/11/91 yields 9.68% (5.868 US/Dkr.)	
3 year	8.04%			EIB 5½% 9/8/93 yields 8.30% (1.521 US/DM)		Canada 5% 23/7/93, yields 7.38% (123.03 US/JY)		Sweden 9% 14/4/93, yields 12.08% (1.747 US/DM)
6 year	8.46%			Quebec Hydro 5½ 1/5/96 yields 9.06% (1.561 US/DM)				
7 year	8.56%			Prov. Quebec 6% 1/4/97 yields 9.06% 1.510 US/DM				
8 year	8.56%				Australia 5% 20/10/98, yields 7.10% (1.143 US/SF)			
Spot Exchange Rate	N/A	.6005	.7695	1.5106	1.2736	125.33	5.752	1.95

*For example, since a US\$-based investor would receive 547 basis points (1338-791) by holding the CIBC NZ\$ bond, the NZ\$ can depreciate to .543 NZ/US from the present spot exchange rate of

.6005 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.

Chart 20 – Foreign Currency Bonds

Date: October 18, 1990

We offer the following Bonds subject to change without prior notice. Minimum amount: US\$5000 (Cdn. \$7,000)

PAY ISSUER/MTY./INT./COUPON	BID	OFFER	CURRENT ANN. YIELD TO MTY.	LAST PAY DATE	NEXT PAY DATE
CANADIAN DOLLAR DENOMINATED BONDS					
GOVERNMENT OF CANADA (semi annual) 05/12/90 to 1/4%	99.55	- 99.85	10.53%	05/06/90-05/12/90	
NEW ZEALAND DOLLAR DENOMINATED BONDS					
CAN. IMP. BANK OF COMMERCE 27/07/92 14% HRSF eligible	100	- 100 3/4	13.38%	27/07/90-27/07/91	
AUSTRALIAN DOLLAR DENOMINATED BONDS					
General Electric 11/07/92 14 1/4% (semi)	102	- 102 3/4	12.77%	11/07/90-11/01/91	
COMMONWEALTH BANK OF AUSTRALIA 01/07/94 14%	101 5/8	- 102 3/8	13.08%	01/07/90-01/07/91	
WORLD BANK 15/03/93 12 3/4% HRSF eligible	100 1/2	- 101 1/4	12.03%	15/03/90-15/03/91	
CAN. IMP. BANK OF COMMERCE 13/03/91 13% HRSF eligible	99 1/2	- 100 1/4	11.41%	13/03/90-13/03/91	
DANISH KRONE DENOMINATED BONDS					
STOCKHOLM 10/11/91 10 5/8%	100 1/8	- 100 7/8	9.68%	10/11/90-10/11/91	
BRITISH POUND DENOMINATED BONDS					
ROY. OF SWEDEN 14/4/93 9 3/8%	93 5/8	- 94 3/8	12.08%	14/04/90-14/04/91	
DEUTSCHE MARK DENOMINATED BONDS					
QUEBEC HYDRO 5 1/2% 1/5/96 HRSF eligible	84 1/4	- 85	9.06%	01/05/90-01/05/91	
PROVINCE OF QUEBEC 6% 1/4/91 HRSF eligible	84 1/4	- 85 1/2	9.06%	01/04/90-01/04/91	
EUROPEAN INV. BANK 5 1/2% 9/8/93	92 1/2	- 93 1/4	8.30%	09/08/90-09/08/91	
BANK OF NOVA SCOTIA 5 5/8% 01/05/96 HRSF eligible	85	- 85 3/4	8.99%	07/05/90-07/05/91	
WORLD BANK 5 7/8% 4/2/97 HRSF eligible	84 3/4	- 85 1/2	8.99%	04/02/90-04/02/91	
SWISS FRANC DENOMINATED BONDS					
GOVT. OF AUSTRALIA 30/10/98 5%	85 1/2	- 87 1/2	7.10%	30/10/89-30/10/90	
JAPANESE YEN DENOMINATED BONDS					
GOVT. OF CANADA 23/7/93 5 5/8% HRSF eligible	95	- 95 3/4	7.38%	23/07/90-23/07/91	
U.S. DOLLAR DENOMINATED FIXED CONVERTIBLE BONDS					
PACIFIC SCIENTIFIC 7 3/4% 15/06/03 (semi) CV \$530 p/sh	65	- 66	13.85%	15/06/90-15/12/90	
SUNSHINE MEDICAL INC. 7.25% 26/6/96 CV \$517 5/8 p/sh	97	- 100 1/2	7.13%	26/06/90-26/06/91	
ALLIANT COMPUTER 7.25% 15/05/12 (semi) CV \$539.75 p/sh	16	- 19 1/2	40.68%	15/05/90-15/11/90	
COOPER CO'S. 10 5/8% 01/03/05 (semi) CV \$527.45 p/sh call in 1995 @100	68 1/2	- 70	16.65%	01/09/90-01/03/91	
DICEON ELECTRONICS 5.5% 1/3/12 (semi) CV \$539.50 p/sh	24	- 25 1/2	23.51%	01/09/90-01/03/91	
U.S. DOLLAR DENOMINATED FIXED RATE BONDS					
ALBERTA 7 3/8% 9/12/91 HRSF eligible	98 7/8	- 99 5/8	7.71%	09/12/89-09/12/90	
SOUTHWEST 12% 10/8/97 (semi)	66 1/2	- 70 1/2	21.15%	10/08/90-10/02/91	
U.S. DOLLAR DENOMINATED FLOATING RATE NOTES					
UNITED KINGDOM 24/9/96 3 mo. LIBID-1/8 (qly)	99.80	- 100.10	8 1/4%	28/06/90-28/09/90	
REPUBLIC OF ITALY 30/4/93 3 mo. Libean (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: FRIEDBERG CAPITAL MARKETS (416) 364-2700

F/MICHEM

THE EXOTICS

Spanish peseta

Spain illustrates well the contradictions inherent in a high-inflation country's joining the EMS. The problem lies in trying to maintain two objectives simultaneously. On one hand, the Central Bank of the high-inflation country would like to slow the growth of money and credit so as to bring down inflation. To that effect, it raises short-term interest rates. But by doing so, it give EMS speculators a profitable arbitrage opportunity, so long as the new member's commitment to the new EMS parity is believed to be ironclad. In effect EMS speculators are able to borrow low interest rate EMS currencies and invest them in the high interest rate EMS currency. This arbitrage operation inflates the money supply of the high inflation currency, thus defeating the first objective.

In the specific case of Spain, with an inflation rate of 6.7%, the Central Bank has set a 6.5% to 9.5% target range for growth of the M4 aggregate and a 10% target for internal credit. It has purported to reach these targets by raising short-term interest rates, which now stand at 14.6% overnight and 14.9% for three months. These attractive rates have caused large short-term inflows with the result that the accumulated rise of M4 after eight months is 9.9%. All this time the peseta remains at the top of the EMS grid.

Strong internal demand and a very high peseta exchange rate (it is at the highest level since 1979 and it has appreciated by 80% since 1985) has caused a dramatic widening of the current account deficit now estimated to reach 3.9% in 1990. The initial surge in capital inflows associated with membership in the EEC seems to be subsiding, and most capital inflows at this time seem to be of a short-term, speculative nature. The opening up of cheap labor markets in Eastern Europe may provide future stiff competition to Spain.

Over time, the widening current account deficit and the convergence of inflation rates will make the currency less attractive.

STRATEGY: *Our dollar views force us to take a long position in pesetas versus the sale of US dollars, but we would remain neutral vis à vis the deutschemark.*

Chart 21 - Rates

Spot	1 Month	3 Month	6 Month	12 Month
94.25 - 94.35	94.70- 94.85	95.65- 95.85	97.00- 99.25	99.75 100.00

FOREX RATES & UPDATE

Currency	Spot	3-Month	12-Month	Comments vis à vis US\$	Comments vis à vis DM (Spot DM: 150.50)
Australian dollar	.7815-.7825	.7725-.7735	.7490-.7520	Buy	Neutral
Belgian franc	31.02-31.07	31.04-31.14	31.23-31.43	Buy	Neutral
Danish krone	5.7375-5.7450	5.7635-5.7770	5.8570-5.8800	Buy	Neutral
Dutch guilder	1.7000-1.7010	1.7010-1.7025	1.7110-1.7140	Buy	Neutral
Greek drachma	151.20-152.00	153.70-161.50	162.20-184.00	Neutral	Neutral
Hong Kong dollar	7.7820-7.7840	7.7775-7.7815	7.7750-7.7780	Neutral	Neutral
Irish punt	1.7760-1.7775	Not available	Not available	Buy	Neutral
Italian lira	1131-1132	1138-1140	1167-1171	Buy	Neutral
Malaysian ringgit	2.6980-2.6990	2.7020-2.7150	2.7100-2.7220	Neutral	Neutral
New Zealand dollar	.6050-.6065	.5950-.5970	.5685-.5720	Neutral	Neutral
Norwegian krone	5.8525-5.8575	5.8940-5.9040	6.0115-6.0315	Buy	Neutral
Portugese escudo	132.20-133.00	134.60-135.00	140.20-145.50	Neutral	Neutral
Saudi Arabian riyal	3.7500-3.7510	3.7500-3.7520	3.7500-3.7540	Remain short	Remain short
Singapore dollar	1.7110-1.7135	1.7080-1.7010	1.7000-1.7100	Neutral	Neutral
Swedish krona	5.5925-5.5975	5.7905-5.7115	5.9525-5.9775	Neutral	Remain short

Explanatory Notes

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

Flash update, Monday, September 17, 4:30 p.m.:

1. Cover short crude oil positions and stand aside.
2. Buy December Japanese yen at market, placing initial stops at 6775, close only.
3. Cover short December DM positions at market, and stand aside.
4. Buy December gold at market, placing initial stops at 380, close only.

Tuesday, September 18:

Repeat of yesterday's flash update.

Wednesday, September 19:

This will replace the regular Friday update. Our next regular update will be Monday, Sept. 24, not Tuesday as usual.

1. Cover short crude oil positions and stand aside.
2. Buy December Japanese yen at market, placing initial stops at 6775, close only.
3. Cover short December DM positions at market, and stand aside.
4. Buy December gold at market, placing initial stops at 380, close only.

Monday, September 24:

No changes or new recommendations. Our next regular update Friday, September 28.

Flash update, Wednesday, September 26, 1:00 p.m.:

One new recommendation: Buy December T-bills and sell December Eurodollars at market as a spread.

Friday, September 28:

As per our flash update on Wednesday 1:00 p.m., we recommended the purchase of December T-bills and sale of the Eurodollars at the market as a spread. One new recommendation: Buy December 9175 Eurodollar put option at market.

Tuesday, October 2:

No changes or new recommendations.

Flash update, Wednesday, October 3:

Friedberg Capital Markets suggests you liquidate all Argentinean Bonex 82. They have risen to yield 20% per annum, a rate not commensurate with risk. No other

recommendations. No update Friday the 5th. Next regular update Monday, October 8, not Tuesday.

Monday, October 8:

No changes or new recommendations. Next update Tuesday, October 9.

Tuesday, October 9:

One new recommendation: Buy December Comex gold at market. Place stops at 383.00, close only.

Wednesday, October 10:

Yesterday we recommended to buy December gold with stops at 383, close only. This recommendation should have been to raise stops to 383, close only from 380 on existing gold positions, purchased as per a recommendation on September 17. Next regular update Monday October 15th

Monday, October 15:

No changes or new recommendations.

Flash update, Wednesday, October 17, 8:45 a.m.:

Cover short Canadian dollar positions at market, accepting profits.

Flash update, Thursday, October 18:

1. Buy December Canadian dollar, risking 8400 close only, establishing a new long position.
2. Buy December Australian dollar, risking 7450, close only.
3. Buy December S&P against short KC Value Line positions on a contract for contract basis.

Friday, October 19:

Repeat of the week's activities:

1. We covered short Canadian dollar positions as per our flash update of Wednesday, October 17.
2. As per yesterday's flash update, we recommended establishing a long December Canadian dollar position with stops at 84.00, close only.
3. As per Thursday's update, we recommended buying Australian dollar with stops at 7450, close only.
4. As per Thursday's update, buy December S & P against short KC Value Line positions on a contract for contract basis.

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Subscription Enquiries
Friedberg's Commodity & Currency Comments
347 Bay Street
2nd Floor
Toronto, Ontario, Canada
M5H 2R7
(416) 364-1171

Trading Accounts
All enquiries concerning trading accounts should be directed to Friedberg Mercantile Group
347 Bay Street
Toronto, Ontario M5H 2R7
(416) 364-2700

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