

# FRIEDBERG'S

## COMMODITY & CURRENCY COMMENTS

Friedberg Commodity Management Inc.



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### CAV\* OK!

The fog over the global foreign exchange markets has lifted.

Unclear and befuddled thinking — based on the flimsiest of evidence — allowed speculative forces to run away with the US dollar, marking it up a spectacular 28% in the short period of 5 months. One by one, the arguments in favor of the dollar bulls fell apart: First it was East Germany — the gloom and doom that had followed initial euphoria was tempered by reports that the Treuhandanstalt had indeed been making headway in the privatization efforts. In May alone 544 companies were sold compared with a mere 400 in all of 1990; blue chip foreign companies of the size of Procter & Gamble, Coca Cola, Asea Brown Boveri, AKZO, St. Gobain, and British Gas were among the investors. The New Germany of angst was giving way to the New Germany of opportunity as George Melloan of *The Wall Street Journal* would so aptly phrase it.

Next, the immediate disintegration of the Soviet Union, followed by civil war, was averted at the last moment by a new constitutional deal negotiated by two former rivals. Prospects for decentralization and economic reform took over from fear of imminent doom (the doom, of course, has been merely postponed into the indefinite future — see next article). Finally, the G-7 bestowed their gracious smiles and wishes on the Soviet Bear. *Voila*. The "Gorby" factor transformed itself from a negative influence on the D-mark to a positive one. Or, at least, the market perceived it so.

Finally, the market's faith in the convergence theory — that the US economy was recovering and the West German one was contracting — began to weaken. First it was US retail sales in June, which fell 0.2% after a downward revised gain of 0.8% in May. Then, durable goods orders fell instead of rising as expected, leaving us with a still well-defined downtrend (see Chart 1).

In between the first and second pieces of evidence that all-was-not-well with the recovery, the market was doused with freezing water: a coordinated intervention by the Federal Reserve, the Bundesbank, and a host of other central banks. More on that later.

The final proof that the US economy was still shaky came on Friday with the July employment data: Payroll employment fell 51,000 last month, while the average workweek fell 0.4 hours to 34.1 hours, producing a sharp decline in

aggregate hours worked. Coupled with the fact that average hourly earnings fell 0.1%, it appears that wage and salary nominal income fell dramatically last month.

At the same time, the German boom has not given any sign of letting up. On July 11, Finance Minister Waigel repeated that he expected second-quarter real GNP data to show a 5% year-over-year growth, while on July 12 he upped his 2.9% growth forecast for the full year of 1991.

With regional CPI numbers pointing to an inflation rate in excess of 4% per annum, prospects for a unified public sector deficit to top DM200 billion (around 8% of GNP), the Bundesbank's range of choices narrowed dramatically: It would have to seek a further round of monetary tightening. The only questions were when and by how much.

Euro-DM rates have already firmed and are now trading at new highs (see Chart 2). One should never underestimate the determination of the Bundesbank or, in the parlance of commodity traders, the tail of the "bull." Both point to substantially higher short-term rates in the near future.

And then there is the matter of Central Bank intervention. Given that the speculative bandwagon had no substance, we maintained for many months that the central bank

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

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

\*Clear and visibility above 10 miles (Dept. of Transport)

could stop it if they only wished — *really* wished — to do so. What was required was determined — *not massive* — intervention. A large quantity of dollars would be lost by foreign central bank intervention if they continued to give the impression that they were merely “smoothing out fluctuations” and making for “orderly markets.” Or if they continued to give the appearance of being divided on the matter: Some cared, some didn't, and those who didn't were being dragged into action. All that was required was a unanimous show of strength that demonstrated to the market their determination to stop the speculative game.

This show of strength came on Friday, July 12. Fifteen central banks sold dollars for EMS currencies (principally the DM), driving the \$/DM down to 1.7830 from 1.84. This concerted action broke the back of the speculation. Of course, as we pointed out earlier, evidence of a lack of economic convergence between the US and Germany were surfacing. The form and timing of the action was impeccable: determination, force, surprise, all coming as the skies were clearing.

What's next? Contrary to all “expert” opinion, the US dollar is not merely correcting a six-month bull market but has actually entered a new downleg of its multi-year bear market. Significantly (at least to those who are technically-minded), the \$/DM recovered no more than two-thirds of its previous mid-1989 to early 1991 decline (the maximum permissible retracement under Dow Theory) and reassuring us dollar bears that, in fact, we were not in the presence of a new bull market.

In keeping with the thesis we advanced in our April 21 issue (“No substance but still heading higher”), the market will advance the “non-convergence” argument in favor of the D-mark bloc of currencies for quite some time yet. The dollar's decline will gather momentum, the new story will slowly become well-known, and later well-worn. Finally, it will become stale. At that point, the dollar bear market will end. We may still be many months away.

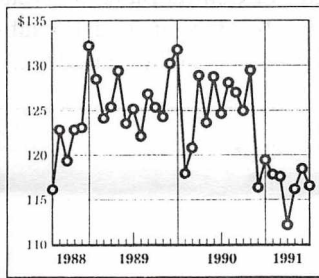
What can change this trend? Renewed unrest over Eastern Europe and the Soviet Union could once again change the focus of the market from one of economic divergence (in favor of Europe) to one of concern about instability, massive displacement of labor, and capital flight (out of Europe). The seeds of this eventual — and almost inevitable — process have been planted: Yugoslavia. To this effect we have asked Dr. Steve Hanke who has been Personal Economic Adviser to the Deputy Minister of Yugoslavia since late 1989, to explain and develop the thesis of a new balkanization of Europe, sensitizing us to the foreign exchange market's next story.

**STRATEGY:** *We have been short US dollars via the purchase of yen futures as of July 1 and the purchase of DM and other EMS currencies since July 18 (see Hotline Update for those days). The tide has clearly turned in our favor. Remain long yen, DM, and other EMS currencies. We have a strong preference for the DM as we believe the DM/yen cross (see Chart 3) will recover significantly in the next few months.*

Chart 1

**Durable Goods**

In billions of dollars.



THE WALL STREET JOURNAL

Chart 2 – LIF Short Euromark Sep '91

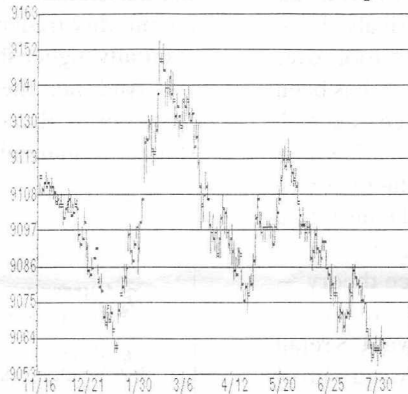


Chart 3 – DM/YEN

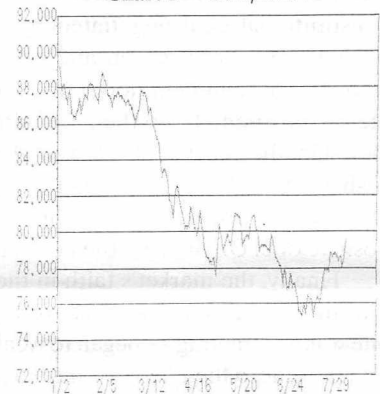


Chart 4 – CME Japanese Yen Sep '91

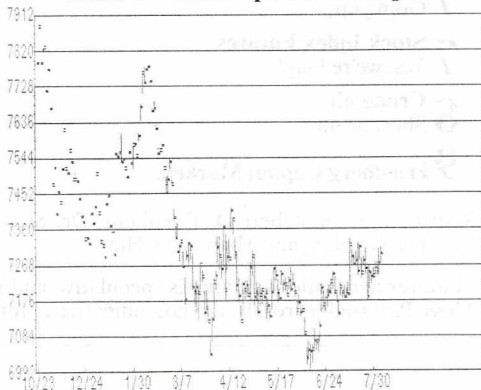
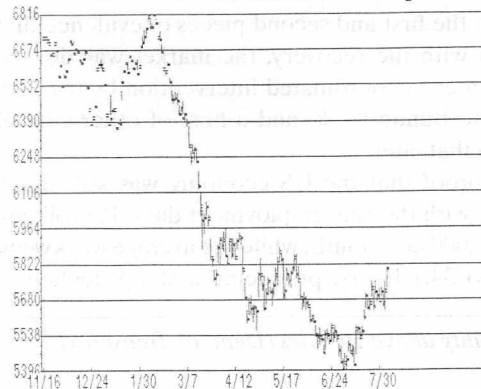


Chart 5 – CME Deutsche Mark Sep '91



**CURRENCY**

# The Balkan shadow

Our April issue contained an article entitled "US dollar: No substance by heading higher." That piece was motivated by an article penned by Dr. Neil Wallace, a pioneer in rational expectations theory. From Dr. Wallace's perspective, there are no inherent fundamentals that determine equilibrium exchange rates. Indeed, he goes so far as to say that exchange rates are totally determined by speculation.

We draw the following conclusions from Dr. Wallace's analysis: Economic fundamentals, in large part, determine long-term trading ranges and trends for currencies, and political fundamentals, in large part, determine short-term moves within trading ranges. Moreover, political fundamentals can affect economic fundamentals and perceptions about risks. Hence, in addition to affecting short-term speculative moves, political fundamentals can ultimately affect long-term trading ranges and trends in the currency markets. The lesson is rather obvious: We must focus a good bit of attention on political fundamentals if we want to trade the currency markets effectively.

## East/West interface

During the past century, the Balkans have been a tinderbox of ethnic groups and nationalities that has occasionally cast a disproportionately large, dark shadow over the West. As Yugoslavia heats up once again, we focus our analysis on that federation, because events in Yugoslavia could have significant consequences for Western Europe. However, before delving into the details of Yugoslavia, we address the economic dynamics working at the interface between East and West.

Although Papa Marx authored *Capital*, he didn't have any kind words for either capital or capitalists. Therefore, we shouldn't be too surprised to find a huge shortage of useable capital in the ruins of communism. As a result of that shortage, the capital-labor ratios in the East are much lower than those in the West, and consequently labor productivity and wages fall dramatically as we move from the West to the East.

The disparity between capital-labor ratios in the West and East has developed because the capital labor flows that would normally push these ratios towards equality were blocked under communism. In the post-communism environment, the impediments have been lifted to some degree. Hence, the equilibrating flows have begun, with capital flowing East and labor flowing West.

Those flows are the most vigorous in unified Germany, where there is a monetary union between the East and West and where flow-impediments have been reduced the most. However, in the other nations of East and Central Europe, as well as the USSR, the impediments to capital and labor flows have not been reduced symmetrically. Specifically, impedi-

ments to labor flows have been reduced much more than those for capital flows.

In the East, the following factors are acting to impede capital flows from the West: Currencies are not convertible; private property rights remain limited and uncertain; political uncertainties are great; macro-economic management is primitive and uncertain; real economic indicators are deteriorating; the socialists (communists) are busy practicing economic sabotage; and ethnic-nationality conflicts are intensifying.

In consequence, capital flows to the East are little more than a trickle. Hence, labor flows to the West are carrying most of the capital-labor ratio adjustment burden. We should not be surprised to observe that both legal and illegal immigrants in Western Europe are surging. Those immigrants have the potential for creating a great deal of short-term political and economic disruption in Western Europe. That potential could spell trouble for Western Europe's economies and currencies.

## Yugoslav casebook

Armed with our economic analysis, let's take a look at the political fundamentals in Yugoslavia, and see how the fit together.

In late 1989, I was invited to accept a position as Personal Economic Adviser to the Deputy Prime Minister of Yugoslavia (the federal government). At that time, the federation was in deep trouble: It was still controlled by unelected communists and was in the middle of an hyperinflation. In December 1989, a currency reform was introduced: We pegged the dinar to the D-mark and made the dinar convertible.

For about six months, that reform, as well as others aimed at transforming the socialist system to a market-based system, actually worked better than I had expected. Indeed, the monthly inflation rate dropped from 58.8% for the month of December 1989 to a negative 0.3% for June 1990, and foreign exchange reserves soared from \$5.2 billion to \$8.7 billion during the same six-month period.

Although industrial production fell by 10% during the first six months of 1990, that drop was not as ominous as it might appear, because most of the output decline occurred in inherently uneconomic enterprises that were being restructured as part of our economic reform program.

Even though some thought I was a free-market guru who could walk on water, I knew better. Indeed, I knew that there were anti-reform elements at work, and that they were attempting to sabotage the economic liberalization program.

The leaders of Yugoslavia's republics want to consolidate their power bases and create little satraps. A successful liberalization program at the federal level is a threat. Hence, they must sabotage it. Indeed, the leaders of the republics

know that they need a full-blown economic crisis to accomplish their objectives, because they can feed off a crisis. By appealing to ethnic and national enmities during an economic crisis, the leaders of the republics can work the populace into a frenzy. In such an environment, Yugoslavs will tyrannize their fellow citizens rather than their bank balances.

In the Yugoslav federal system of government, the republics retain, either formally or informally, control over most of the levers of economic power. Hence, the leaders of the republics have the power to sabotage liberal economic reforms implemented by the relatively weak federal government, and to create a full-blown crisis.

In consequence, I knew our program was under attack when the warlords from the republics allowed public spending at the republic and municipal levels to spiral out of control. (Collective consumption grew at a 7.5% real rate during the first eight months of 1990.) If that wasn't enough of a warning, worker-managed firms (virtually all the firms in Yugoslavia) allowed their nominal wages to increase by 48% from June 1990 through September of that year. (Note that with the worker-managed system, workers are managers and vice versa; hence, there are no labor markets. Moreover, the worker-managers are controlled by the political apparatus.)

With these two major sabotage ploys (there were many minor ones), it was obvious that a crisis was brewing, that the warlords would be able to feed off it, and that Yugoslavia would move closer to the brink of a full-scale civil war. For doubters, more blatant evidence was revealed in early 1991, when the federal government foiled a plot by the National Bank of Serbia (a "branch" of the central bank) to issue \$1.8 billion in unauthorized credits to worker-managed firms in Serbia. That bold attempt at embezzlement was intended to finance the huge wage increases that Serbian workers had granted to themselves in 1990.

The economic sabotage is working. The warlords have control over too many powerful economic levers and have used them with reckless abandon. The results are devastating. The dinar is devalued and is no longer convertible; foreign reserves have reversed course and are down to about \$4 billion; inflation is steadily increasing and is about ready

to surge; industrial production is completely collapsing; and the unemployment rate is approaching 30%.

The federation is well on its way to a huge balance of payments crisis, with its largest sources of foreign exchange (tourism and repatriated wage earnings) drying up. The price of Yugoslavia's foreign debt tells the whole story about the success of the warlords' sabotage: After moving up to 62 in 1990, that debt is now trading in the mid to high 20s.

Our overall appraisal of the Yugoslav prospects for the next six months looks like this:

1. 10%: An overall peace settlement, with a new confederate structure replacing the existing federal structure.
2. 40%: An escalation in the confrontation, with full-scale civil war breaking out.
3. 50%: A stalemate, with current levels of scattered violence (10 to 100 casualties per week).

We are monitoring the developments in Yugoslavia carefully. If the current nasty stalemate takes a turn for the worse, there would be violent dissolution of the federation. Yugoslavia would become another Lebanon, and at least 10% of the population (about 2.5 million) would emigrate, primarily to Western Europe. Recall the dynamics of the capital-labor adjustment process.

In addition, Yugoslavia would default on its \$15 billion foreign debt. The perceived political risks for investments throughout all of Europe would increase, and there would be a capital flight from the Continent, just when that region has become a net importer of capital. European interest rates would increase, and the region's growth would slow. It goes without saying that the Continental currencies would come under pressure, particularly the D-mark, Austrian schilling, and Italian lira.

If all of this isn't enough to cause concern, recall that Yugoslavia contains exactly the same explosive ingredients as the biggest monster conceived by Papa Marx: the Soviet Union. Indeed, Yugoslavia is nothing more than a miniature of the USSR. Hence, in addition to the reasons enumerated, we monitor Yugoslav developments because they provide a good leading indicator of what we can expect in the USSR.

— Dr. Steve H. Hanke

## **SUGAR**

# A bull market is born

For months, the trade has bid up the nearest contract to a premium, a very unusual development in a presumably well-supplied market. For months, all we heard was that Japanese refiners were experiencing delays in prompt shipments, especially from Thailand. As Thailand is not the only sugar producer in the world, we wondered why — given forecasts that sugar was plentiful — were Japanese refiners not shopping elsewhere rather than paying stiff prompt delivery premiums. Surely, the bottleneck could only be temporary or

just long enough for commodity arbitrageurs to ply their trade.

To our surprise, the backwardation has persisted. The NY Raw Sugar #11 July '91 contract expired 218 points above October 91. In London the August '91 contract expired \$55/ton above October '91, an incredible 25% premium above the next nearest contract.

F.O. Licht's supply/demand forecast (the bible of the sugar trade) points to a significant rise in final stocks and its

ratio to use for the 1990-91 year (see Charts 6 and 7).

On the face of it, sugar prices have nowhere to go but down. That is not, however, what the persistent backwardation is telling us. In fact, as we revisited the historical record, we discovered — not to our surprise — that backwardations were events associated with tightening sugar supplies and *always* preceded and accompanied the great bull markets of the past 20 years (1971-74; 1979-80). Even more comforting, no persistent backwardation episode was found to be followed by bear markets.

As we begin to accumulate long positions, we hear of “delays” (is the sugar really there?) in Cuban deliveries, a large drop in the Queensland, Australia sugar crop (below 3 million tons vs. 3.3 million tons last year and an optimum production for the state of 3.5 million to 4.0 million tons), a sharp drop in Soviet production and a “story” circulating in the trade that they have been substantial buyers in the world market over the past few months. Clearly, “something” must be happening.

Before we get carried away with visions of 35¢ to 65¢/lb. sugar, we must realize that the deflationary '90s are a far cry from the inflationary '70s; almost without exception, commodity prices in recent months and years have been in a downtrend caused by slower money supply growth, better inventory control methods, and major technological advances

in production.

It is *possible* that persistent spot premiums will help the market weather the storm. Not likely, though. Backwardations tend to reallocate supplies, paying a premium to those in possession of prompt supplies; low deferred prices, however, do not provide sufficient incentive for producers to lock in profitable hedges.

To cope with tightening supplies you need both high absolute prices, to incentivize increases in production and decreases in consumption, and a backwardation, to help mobilize present idle supplies by attracting “lenders” to the market. Having said that, in an overall deflationary environment, prices need not rise as dramatically as they did in the past, to alleviate the *ex ante* supply shortage.

In sum, the sugar market is displaying the characteristics of a nascent bull market: backwardation (spot commands a premium over more deferred contracts); low speculative interest (open interest is at relatively low levels), a bearish “informed view” that diverges from the market’s reality.

We are happy to say that once again (the last time was in 1972-73) we are sugar bulls.

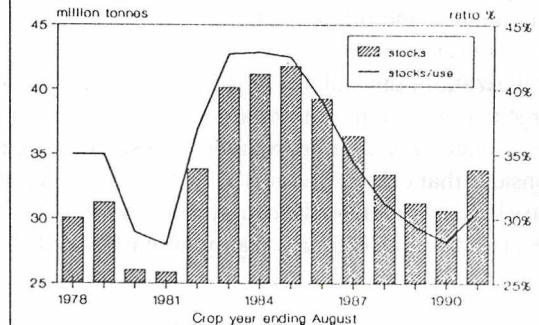
**STRATEGY:** We bought October '91 sugar, at around 9.29, as per Hotline Update of July 26 (see Hotline Update review). Maintain stops at 8.50, close only.

**Chart 6**  
World Sugar Balance  
— in millions of tonnes —

	1987-88	1988-89	1989-90	1990-91		
				1st Est	2nd Est	3rd Est
Beginning Stocks	36.44	33.46	31.23	29.34	30.13	30.63
Production	104.79	104.64	109.19	111.99	112.80	114.15
Imports	27.78	29.63	28.73	29.81	29.32	29.20
<b>Total Supply</b>	<b>169.01</b>	<b>167.73</b>	<b>169.15</b>	<b>171.15</b>	<b>172.26</b>	<b>173.98</b>
Consumption	107.03	106.27	108.59	110.86	109.47	110.32
Exports	28.53	30.23	29.94	30.03	29.61	29.84
<b>Total Disappearance</b>	<b>135.56</b>	<b>136.50</b>	<b>138.53</b>	<b>140.40</b>	<b>139.08</b>	<b>140.16</b>
<b>Final Stocks</b>	<b>33.46</b>	<b>31.23</b>	<b>30.63</b>	<b>30.75</b>	<b>33.18</b>	<b>33.83</b>

Totals may not add due to rounding. Source: F.O. Licht

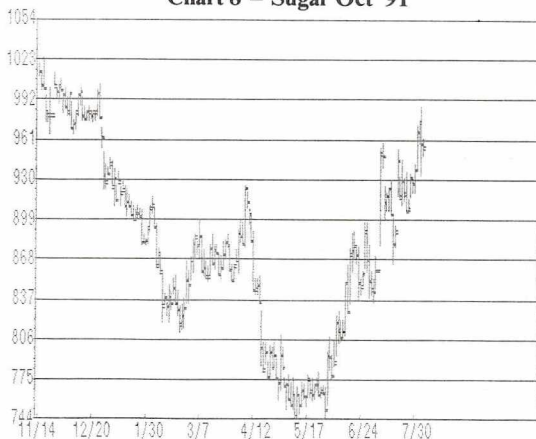
**Chart 7**  
Actual World Sugar Stocks  
and the Stocks/Use Ratio



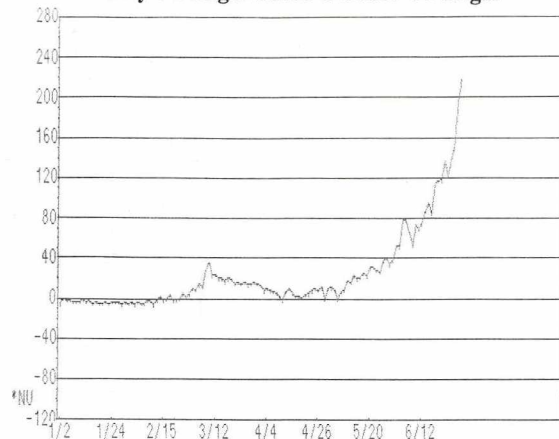
Source: F.O. Licht

Merrill Lynch, Pierce, Fenner & Smith Inc.

**Chart 8 – Sugar Oct '91**



**Chart 9**  
July '91 Sugar minus October '91 Sugar



**T-BOND FUTURES**

# Dollarization of bond yields

Citizens of Eastern Europe, the Soviet Union, and South America spend a great deal of time and energy attempting to protect their wealth from expropriation that occurs because of inflation and ill-considered currency reforms. To accomplish their objective, these individuals, among other things, attempt to substitute foreign currency for their domestic currencies. Where the dollar is the preferred currency, as it is in the regions mentioned above, that currency substitution is referred to as "dollarization."

Dollarization is spreading on a grand scale, particularly since the countries in the East have "opened up." To put the dollarization phenomenon into context, allow me to review some findings presented in my recent book on monetary policy in Argentina.

The currency supply ( $M_1$ ) of australs represents about 7% of gross national product (GNP), or about \$5 billion. The estimated stock of dollars in Argentina — that is, hand-to-hand currency — is \$3 billion to \$7 billion. In addition, there is approximately another \$3 billion on deposit in banks located in Argentina. Hence the value of the dollar money supply ( $M_1$ ) in Argentina exceeds the value of the austral money supply. It should not surprise us, therefore, to observe that all significant commercial transactions in Argentina are priced in dollars, and that large bundles of greenback facilitate these transactions.

Dollarization, the leakage of greenback from the USA, is so large and uncertain as to render official data about the adjusted monetary base rather tenuous at best. To appreciate this, consider that currency contributed 92% of the reported monetary base growth from December 1989 through December 1990. However, we estimate that between 40% and 60% of

the currency growth leaked from the USA because of dollarization. That throws the official data about the monetary base into question, and dramatically reduces their usefulness as guides for monetary policy.

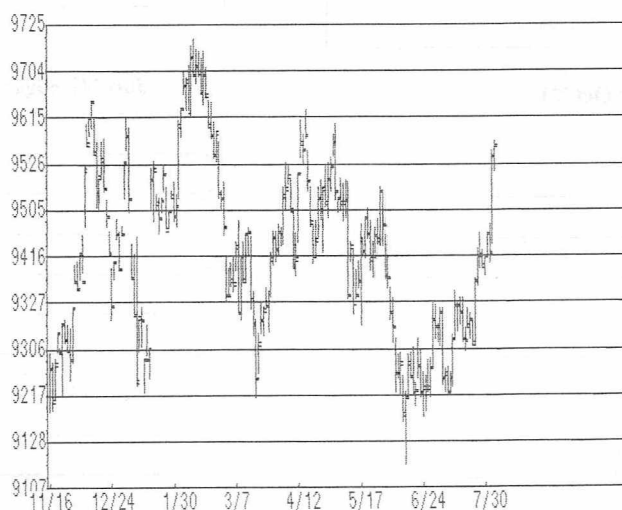
Officially, the monetary base in the USA grew by 8.75% in 1990. However, at a 40% currency leakage rate, the actual US base grew in 1990 by 5.5%, and at a 60% currency leakage rate, the actual US base grew only by 3.9%. Therefore, even though we don't know exactly how fast the monetary base has been growing, we do know that it has been growing much less rapidly than the official statistics would lead us to believe.

**Implications:** The bond markets haven't digested the consequences of dollarization. In consequence, bond yields are unsustainably high. Long bond yields will fall. Historical data on both the slope and height of the yield curve also support our conclusion: When both the slope and height of the yield curve are above average, as they are now, bonds have outperformed cash; also, when the slope of the yield curve is positive and the yield spread between T-bills and long Treasuries exceeds 200 basis points, as it does now, long yields have come down in future periods. For example, during the last 35 years, the positive yield spread has exceeded 200 basis points in four years. The subsequent change in long-term T-bond yields over the next three years has been -37, -110, and -224 basis points, respectively.

**STRATEGY:** Purchase one half position in September T-bonds at the market; add the other half of the position at 94 1/2 or better; and place stop at 92 1/2, close only.

— Dr. Steve H. Hanke

Chart 10 – CBT T-Bond (day) Sep '91



**CANADIAN DOLLAR**

**Going up**

A sharp sell-off, caused by the disclosure of a political scandal that threatened to engulf highly-placed officials, prompted the Bank of Canada to intervene in two ways: selling US dollars and raising the interest rate differential vis à vis US short-term rates to 30 from 240 basis points. It worked like a charm: The BOC sold the US unit at \$1.16-\$1.1650 and repurchased it at \$1.1480-\$1.1520. Hey, would they take a job at FMG?

Year-over-year  $M_2$  growth is beginning to exceed prudential levels associated with stated inflation targets (see Chart 11). The BOC is likely to begin tightening, if ever so slightly. This action should translate into higher Canadian dollar levels.

**STRATEGY:** In line with previous recommendations, we took advantage of 50 to 75-point dips to add to our long positions. Call options remain extremely attractive.

Chart 11

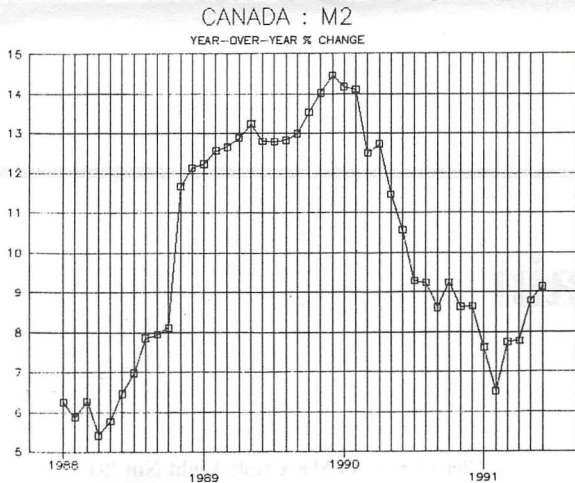
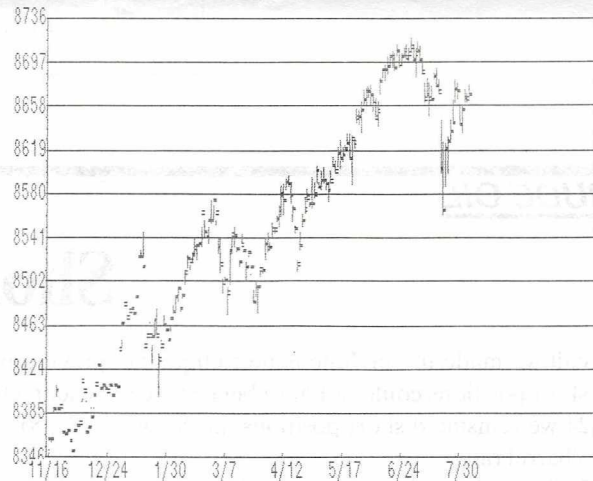


Chart 12 - CME Can. Dollars Sep '91



**STOCK INDEX FUTURES**

**Yes, we're long!**

Despite meager growth of the broader aggregates, banks continue to shun loans and have recently accelerated their acquisitions of debt, primarily government paper.

The continued reliquification of the banking system (see Chart 13) is positive for stock prices.

Sensing a very weak and worse-than-expected quarterly earnings report, we were tempted to short the market via puts just prior to release of early corporate results (July 7 to 10). As it turns out, corporate net income as reported by *The Wall Street Journal* fell 25% from the weak year-earlier period. Attesting to its strength, however, the market held important support in the area of Dow Industrial 2850-2900 and forced us to quickly abandon the short side and once again buy calls.

A market that does not want to go down when it should heads higher.

**STRATEGY:** Remain long September 390 S&P 500 calls.

Chart 13

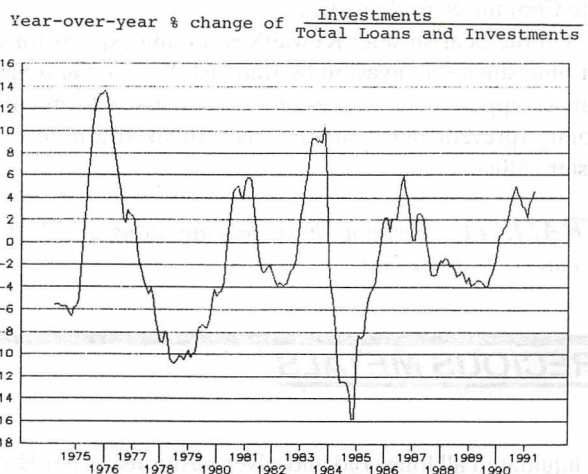
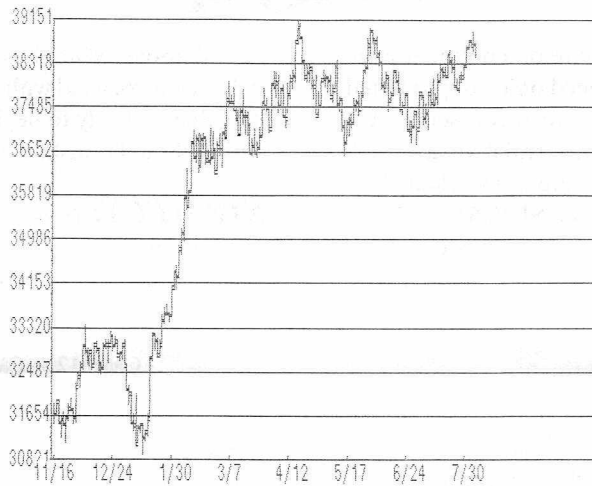


Chart 14 – CME S&P 500 Index Nov '91



**CRUDE OIL**

**Short again**

The call we made in our June issue to liquidate previously-held short positions could not have been more prescient. On July 24 we reinstated short positions, in the wake of a \$1 to \$1.50/barrel rally.

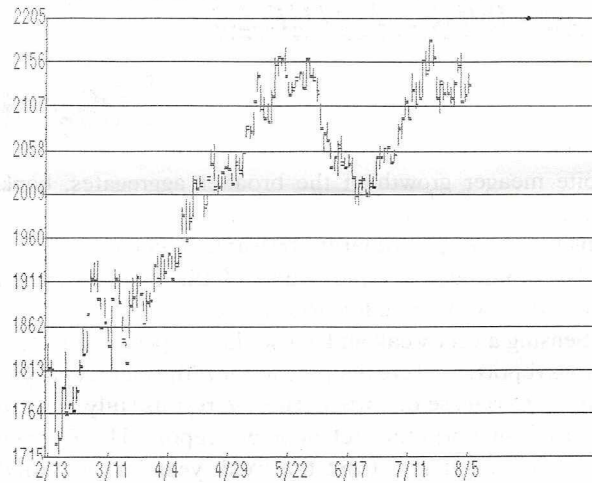
Bulls take heart from the possibility Iraq will find it more difficult than anticipated to disembargo itself now that UN observers have unearthed four times as much weaponry as the country admitted prior to the search.

Ongoing dislocations in the USSR, which, not inconceivably, could degenerate into full-blown chaos, are also part of the bullish case. For the first six months of 1991, Soviet oil exports dropped 50% and oil-based products 52% compared with the same period last year according to the State Committee for Statistics.

On the bearish side: Kuwait's resuming exports for the first time since the invasion by Iraq last August 2 and Saudi Arabia's apparent willingness to open the tap to maintain stability (prevent bull markets?) as a thank-you note to its Western allies.

**STRATEGY:** Remain short, leaving stops at 22, basis November '91, close only.

Chart 15 – NYME Crude Light Nov '91



**PRECIOUS METALS**

We liquidated all long gold and silver positions, as per Hotline Update of July 11. Stand aside.

**FRIEDBERG CAPITAL MARKETS**

## Escom bonds: attractive yields but with strong caveats

Escom, the South African Electricity Supply Commission, has some R18 billion in bonds outstanding; 44% of this total is now held by non-South African investors.

South Africa has a dual currency system: a commercial rand, primarily for commercial transactions such as exports and imports, and dividend and interest remittances; and a freely-traded financial rand for the rest. The financial rand trades at a discount to the commercial rand (see Chart 17). This discount narrowed significantly in recent months as South Africa began to dismantle apartheid and then gained some sympathy from the West.

Since the bonds are purchased in the cheaper financial rand and the dividends are received in the dearer commercial rand, a foreign investor could enjoy a double-barrelled play: a high yield (made higher by the fact that the principal of the bond is bought "cheaply" and the interest is received in

a "stronger" currency); and a potential capital gain if and when the financial rand narrows its discount to the commercial rand.

With the discount hovering around 10%, most of the double barrelled play is over. In fact there are now two distinct risks: a) the stubborn double-digit inflation forces a continuous depreciation of the rand (both financial and commercial; see Chart 16); and b) the financial rand *could* widen the discount if anything "goes wrong" in the next transitional phase (a much more militant ANC, continuous and intense tribal civil strife, etc.)

Short term, a *small* commitment is justified given the attractive *nominal* yields, so long as the financial rand can be purchased at least 6% cheaper than the commercial rand. Longer term, the risks far outweigh the benefits.

We offer, subject to change:

**South African rand-denominated bonds**  
**Escom 11%, due 30/11/93 (semi-annual)**  
**Price: 91**  
**Yield to maturity: 15.92%.**

Chart 16



Chart 17



## Cooper Companies

**Cooper 10 5/8%, due 01/03/05**  
**Convertible at \$27.45 per share**  
**Current price: 81 1/2**  
**Yield to maturity: 14.12%**

Cooper Companies reported negative earnings for the recent quarter ended April 30, 1991. However, this is to be expected as the company continues its ongoing search for acquisitions. Total assets of the company stand at \$203 million, which is well in excess of its total liabilities of \$123 million. The company has remained in a highly liquid position with cash of \$127 million.

The company feels, as we do, that its convertible deben-

tures are a bargain. As a result, they have continued to purchase their outstanding bonds. In the recent quarter alone the company purchased their CV debentures to the tune of \$23 million face value. This purchase resulted in extraordinary gain for the company of \$7.5 million and a tax benefit of \$1.4 million, resulting from the utilization of net operating loss carry forwards. Needless to say, the interest expense that the company pays on its debt is being lowered as purchases continue.

In recent developments, Cooper companies has sent a formal proposal to Marquest Medical Products Inc. offering to buy the Englewood, Colorado, company's stock at \$15 per share in cash. Marquest has approximately 4.3 million shares outstanding, and is primarily a manufacturer of respiratory

equipment and medical products. Cooper presently holds 4.9% of Marquest shares.

This convertible bond remains attractive priced given its excellent asset coverage.

## Diceon Electronics

**Diceon 5½%, due 1/3/2012**  
**Convertible at 39.50 per share**  
**Recent price: 12½**  
**Yield to maturity: 18.83%**

Even though Diceon's second quarter loss widened considerably from the same period last year, overall balance sheet strength has not been greatly impaired: net current assets plus marketable securities at cost about equal the *par* value of its long-term debt, represented primarily by \$32 million face value of convertibles.

At the same time the company has continued to implement a cost-reduction program. The chairman and vice-chairman of the board have reduced their salaries to \$1 for the period Jan. 1, 1991, to Sept. 30, 1991.

Interest and principal seem relatively secure and provide a very attractive yield; a turnaround in the business could eventually put into play the convertibility feature, now available for "free."

**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\$, DM, SF, DKr, BP, FFr, Cdn, ECU) or revalue (JY) before the interest rate advantage/disadvantage is overcome by currency depreciation/appreciation. **Rates as of July 31, 1991.**

	U.S. \$	NEW ZEALAND \$	AUSTRALIAN \$	DEUTSCHEMARK	SWISS FRANC	JAPANESE YEN	DANISH KRONE	BRITISH POUND	FRENCH FRANC	EUROPEAN CURRENCY UNIT	CANADIAN DOLLAR	SOUTH AFRICAN RAND**
1 year	6.21%	CIBC 14%, 27/7/92, yields 8.83% (.5577 NZ/US)	Gen. Elect. 14%, 92 yields 10.01% (.7506 A\$/US)				Denmark 9%, 92, yields 9.53% (6.964 Dkr/US)					
2 year	6.84%	Tourist Hotel 0%, 93 yields 9.65% (.5425 NZ/US)	World Bank 12½%, 93, yields 9.51% (.7401 A\$/US)	E.I.B. 5½%, 93 yields 8.30% (1.793 US/DM)		Canada 5½%, 93, yields 6.49% (136.80 US/JY)		Sweden 9½%, 93 yields 10.15% (1.5852 BP/US)				ESCOM 11%, 93, yields 15.92% (.2640 US/SAR)
3 year	7.21%		CBA 14%, 94, yields 11.23% (.6962 A\$/US)									
4 year	7.36%							EIB 8½%, 95, yields 8.90% (6.281 FFr/US)				
5 year	7.80%			Bk. of Nova Scotia 5%, 96, yields 8.60% (1.811 US/DM)							Ontario Hydro 10%, 96, yields 10.02% (1.1452 US/CD)	
6 year	7.91%			World Bank 5½%, 97 yields 8.57% (US/DM)								
7 year	8.06%				Australia 5%, 98 yields 6.51% (1.408 US/SF)							
10 year	8.20%								U.K. 9½%, 21/2/01 yields 9.16% (1.077 ECU/US)			
Spot Exchange Rate	N/A	.5715	.7775	1.745	1.5227	137.70	6.7535	1.685	5.933	1.1765	1.1526	.31075

\*For example, since a US\$-based investor would receive 908 basis points (1592-684) by holding the ESCOM SAR bond, the SAR can depreciate to .2640 US/SAR from the present spot exchange rate of

.31075 US/SAR over the next 2 years for the SAR investment to break even with current US\$ rates of interest. Assumes that bonds are held to maturity, and coupons are reinvested.

\*\*NOTE: These bonds pay interest in commercial rand, which presently trades at a premium to the financial rand used for this table.

### Recommended bond portfolio allocation for new portfolios

For new portfolios, we recommend the following investments:

DM and/or ECU fixed-rate bonds	75%
US dollar high-yield or convertible bonds	20%
New Zealand dollar bonds	5%

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Chart 18 - Foreign Currency Bonds

HOTLINE UPDATE

Date: July 31, 1991

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

ISSUER/MATURITY DATE/COUPON	BID	OFFER	Current Ann. Yield to MTY.	NEXT PAY DATE	ISSUER/MATURITY DATE/COUPON	BID	OFFER	Current Ann. Yield to MTY.	NEXT PAY DATE
<b>SOUTH AFRICAN RAND DENOMINATED BONDS</b>					<b>NEW ZEALAND DOLLAR DENOMINATED BONDS</b>				
ESCOM 11% 31/10/93 (semi)	90 1/4	- 91	15.92%	Oct. 31	CDN. IMP. BANK OF COMMERCE 27/07/92 14% RRSP eligible	103 3/4	- 104 1/2	8.83%	Jul. 27
<b>DEUTSCHE MARK DENOMINATED BONDS</b>					<b>AUSTRALIAN DOLLAR DENOMINATED BONDS</b>				
KINGDOM OF SWEDEN 7 1/4% 1/2/95	96 1/4	- 97	8.25%	Feb. 1	Tourist Hotel OÜ 04/06/93	83 3/4	- 84 1/2	9.65%	matures Jun. 1993
EUROPEAN INV. BANK 5 1/2% 9/8/93	94 1/4	- 95	8.30%	Aug. 9	<b>U.S. DOLLAR DENOMINATED FIXED CONVERTIBLE BONDS</b>				
BANK OF NOVA SCOTIA 5 5/8% 07/05/96 RRSP eligible	88	- 88 3/4	8.60%	May. 7	General Electric 11/07/92 14 1/4% (semi)	103 1/8	- 103 7/8	10.01%	Jul. 11
WORLD BANK 5 7/8% 4/2/97 RRSP eligible	87 3/4	- 88 1/2	8.57%	Feb. 4	COMMONWEALTH BANK OF AUSTRALIA 01/07/94 14%	105 3/4	- 106 1/2	11.23%	Jul. 1
QUEBEC HYDRO 5 1/2% 1/5/96 RRSP eligible	86	-		May. 1	WORLD BANK 15/03/93 12 3/4% RRSP eligible	103 3/4	- 104 1/2	9.51%	Mar. 3
<b>SWISS FRANC DENOMINATED BONDS</b>					<b>U.S. DOLLAR DENOMINATED FIXED CONVERTIBLE BONDS</b>				
GOVT. OF AUSTRALIA 5% 30/10/98	89 1/2	- 91 1/2	6.51%	Oct. 30	PACIFIC SCIENTIFIC 7 3/4% 15/06/03(semi)	73	- 75 1/2	11.94%	Dec. 15
<b>DANISH KRONER DENOMINATED BONDS</b>					<b>U.S. DOLLAR DENOMINATED FIXED CONVERTIBLE BONDS</b>				
KINGDOM OF DENMARK 9% 20/11/92	98.55	- 99.30	9.53%	Nov. 20	ALLIANT COMPUTER 7.25% 15/05/12(semi)	15	- 19	41.75%	Nov. 15
<b>ECU DENOMINATED BONDS</b>					<b>U.S. DOLLAR DENOMINATED FIXED CONVERTIBLE BONDS</b>				
UNITED KINGDOM 9 1/8% 21/02/01	98.92	- 99.67	9.16%	Feb. 21	COOPER COS. 10 5/8% 01/03/05(semi)	78 1/2	- 81 1/2	14.12%	Sep. 1
<b>BRITISH POUND DENOMINATED BONDS</b>					<b>U.S. DOLLAR DENOMINATED FIXED CONVERTIBLE BONDS</b>				
REGM OF SWEDEN 9 1/8% 14/4/93	98	- 98 3/4	10.15%	Apr. 14	CV \$27.45 p/sh call in 1995 @100	30	- 32 1/2	18.83%	Sep. 1
<b>FRENCH FRANC DENOMINATED BONDS</b>					<b>U.S. DOLLAR DENOMINATED FIXED CONVERTIBLE BONDS</b>				
EUROPEAN INV. BANK 8 3/4% 12/7/95	98 3/4	- 99 1/2	8.90%	Jul. 12	CV \$39.50 p/sh	55	- 57 1/2	24.75%	Nov. 15
<b>JAPANESE YEN DENOMINATED BONDS</b>					<b>U.S. DOLLAR DENOMINATED FIXED RATE BONDS</b>				
GOVT. OF CANADA 23/7/93 5 5/8% RRSP eligible	97.70	- 98.45	6.49%	Jul. 23	SOUTHPARK 12% 10/8/97 (semi)	51 1/2	- 63	7.99%	Jan. 15
<b>CANADIAN DOLLAR DENOMINATED BONDS</b>					<b>U.S. DOLLAR DENOMINATED FLOATING RATE NOTES</b>				
ONTARIO HYDRO 10 7/8% 08/01/96 (semi annual)	102 1/4	- 103	10.02%	Jul. 8	99.90 - 100.10	5	15/16%		Sept. 30
GOVERNMENT OF CANADA (semi annual) 01/09/91 9%	99.80	-		Sep. 1	3 mo. LIBID-1/8 (qly) *callable @100 09/91	99.55 - 99.95	6	1/32%	Oct. 31

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/MICHM

FOREX RATES & UPDATE

Currency	Spot	3-Month	12-Month	Comments vis à vis US\$	Comments vis à vis DM (Spot DM: 1.72005)
Australian dollar	.7807-.7814	.7728-.7739	.7645-.7675	Neutral	Neutral
*Belgian franc	35.44-35.48	35.72-35.82	36.43-36.67	Remain long	Neutral
*Danish krone	6.6640-6.6690	6.7215-6.7325	6.8750-6.8950	Remain long	Neutral
*Dutch guilder	1.9430-1.9440	1.9261-1.9276	2.0013-2.0043	Remain long	Neutral
Finnish markka	4.1850-4.1870	4.2345-4.2395	4.3810-4.3930	Neutral	Neutral
Greek drachma	189.70-190.00	194.70-199.00	210.70-227.00	Neutral	Neutral
Hong Kong dollar	7.7613-7.7623	7.7593-7.7673	7.7763-7.8073	Neutral	Neutral
*Irish punt	1.5430-1.5445	1.5245-1.5280	1.5085-1.5190	Remain long	Neutral
*Italian lira	1287-1288	1305-1307	1357-1361	Remain long	Neutral
Malaysian ringgit	2.7785-2.7810	2.7925-2.7960	2.8000-2.8100	Neutral	Neutral
New Zealand dollar	.5755-.5765	.5706-.5721	.5593-.5623	Remain long	Remain long
Norwegian krone	6.7350-6.7400	6.8055-6.8155	6.9760-6.9960	Neutral	Neutral
Portugese escudo	147.60-147.80	150.70-151.80	158.10-161.80	Neutral	Remain long
Saudi Arabian riyal	3.7500-3.7510	3.7493-3.7515	3.7515-3.7540	Neutral	Neutral
Singapore dollar	1.7255-1.7270	1.7265-1.7285	1.7265-1.7320	Neutral	Neutral
*Spanish peseta	108.05-108.15	109.80-110.00	115.05-115.45	Remain long	Neutral
Swedish krona	6.2600-6.2650	6.3360-6.3455	6.5355-6.5555	Neutral	Neutral

Explanatory Notes

\*As per Hotline Update of July 18, 1991.

Currency expected to firm against both currencies.

Currency expected to strengthen against US\$ and weaken against DM.

Currency expected to weaken against both major currencies.

Currency expected to weaken against US\$, but strengthen against DM.

Term used to liquidate short position but does not imply a new buy recommendation.

Term used to indicate sale advice of previous long position, but does not imply a new short sale recommendation.

Buy Buy  
Buy Sell  
Sell Sell  
Sell Buy

Cover

Liquidate

**HOTLINE UPDATE**

**Friday, June 21:**

There is only one new recommendation: Cover crude oil short positions at market.

**Tuesday, June 25:**

There are no changes or new recommendations. The market letter is in the mail.

**Flash update, Wednesday, June 26, 10:28 a.m.:**

Liquidate outstanding long call options positions in S&P 500 and purchase July 370 S&P puts at the market. This will be an attempt to anticipate the long-awaited decline prior to the release of second-quarter earnings report due to trickle in starting July 7.

**Friday, June 28:**

We repeat Wednesday June 26, flash update. Liquidate outstanding long call options positions in S&P 500 and purchase July 370 S&P puts at the market, currently trading at 550. This will be an attempt to anticipate the long awaited decline prior to the release of second-quarter earnings report due to trickle in starting July 7.

One new recommendation: Liquidate the long DM/short JY cross if the September '91 cross, traded on the IMM, opens lower this coming Monday. By "opening lower," we mean that the high of the opening range will be 7567 or lower. This order is only good by Monday's opening. Otherwise place stops at 75 even, close only.

**Flash update, Monday, July 1, 10:30 a.m.:**

Two recommendations:

1. Liquidate Yen/DM cross trade at the market.
2. We will be once again entering a short position in the US dollar, but this time our preference is in the JY. Therefore, buy September JY at the market. Place initial stops at 7130, close only.

**Tuesday, July 2:**

Repeat of Monday's flash update.

1. Liquidate Yen/DM cross trade at the market.
2. We will be once again entering a short position in the US dollar but this time our preference is in the JY. Therefore, buy September JY at the market. Place stops at 7130, close only.

There are no other changes or recommendations.

**Friday, July 5:**

There are no changes or new recommendations. The following is a repeat of Monday's flash update.

1. Liquidate Yen/DM cross trade at the market.
2. We will be once again entering a short position in the US dollar but this time our preference is in the JY. Therefore, buy September JY at the market. Place stops at 7130, close only.

There are no other changes or recommendations.

**Flash update, Monday, July 8, 3:45 p.m.:**

Stock market is reacting well to the early earnings report, indicating that in all probability the recent decline is over. Therefore, liquidate recently purchased July 370 S&P puts at the market.

**Tuesday, July 9:**

There are no changes or recommendations.

**Flash update, Thursday, July 11, 8:50 a.m.:**

Liquidate immediately all long gold and silver positions at the market.

**Friday, July 12:**

There are no changes or new recommendations. The following is a recap of this week's recommendations: On Monday, July 8 we liquidated July 370 S&P puts at the market and on Thursday, July 11, we liquidated all long gold and silver positions at the market.

**Tuesday, July 16:**

Buy September 390 S&P call options at the market.

**Flash update, Thursday, July 18:**

Finally the US dollar has conclusively broken below its January-July uptrend. In our July 1 flash update we suggested going short the dollar via buying Japanese yen futures -- a conservative approach. We would now like to add long positions in all European currencies, with particular emphasis on the DM. Buy September '91 DM and place stops to coincide with spot interbank crossing the 180.30 anytime.

**Friday, July 19:**

Following is a recap of this week's recommendations: On Tuesday, July 16, we purchased September 390 S&P call options at the market. At the opening on Thursday July 18, we reentered the long side of the EMS currencies with our preference in the September 91 DM, placing stops to coincide with spot interbank crossing 180.30 anytime.

**Tuesday, July 23:**

There are no change or new recommendations.

**Flash update, Wednesday, July 24, 9:50 a.m.:**

Sell November crude oil at the market, risking a close above \$22.00.

**July 26, 1991:**

Good afternoon for Friday, July 26, 1991. This is a hotline update: Following is a complete summary since our last market letter dated June 20, 1991, of all liquidations of open positions, and new recommendations that remain outstanding:

On June 26 we liquidated our S&P 500 call options. On July 1, we liquidated our losing DM/JY cross and purchased September JY at the market, then around 7210. An initial stop was placed at 7130, close only.

On July 11, we liquidated our profitable longs in both gold and silver. On July 16, we purchased September 390 S&P 500 options, then around 690 points.

On July 18, we advised going long EMS currencies with particular emphasis on the DM. The September DM was then trading at around 5620. Initial stops were placed at 180.30, basis spot interbank.

On July 24, we established a short position in November crude oil then trading at around 2111 and placed stops at 2200, close only.

One new recommendation: buy October sugar at the market, place initial stops at 850, close only.

Have a great weekend. Thanks for calling.

**Tuesday, July 30:**

A repeat of the new recommendation made on the regular hotline update for Friday, July 26.

Buy October sugar at the market. No new changes or recommendations.

**Friday, August 2, 1991:**

This is a hotline update. Following is a complete summary since our last market letter dated June 20, 1991, of all liquidations of open positions, and new recommendations that remain outstanding:

On June 26 we liquidated our S&P 500 call options. On July 1, we liquidated our losing DM/JY cross and purchased September JY at the market, then around 7210. An initial stop was placed at 7130, close only.

On July 11, we liquidated our profitable longs in both gold and silver. On July 16, we purchased September 390 S&P 500 options, then around 690 points.

On July 18, we advised going long EMS currencies with particular emphasis on the DM. The September DM was then trading at around 5620. Initial stops were placed at 180.30, basis spot interbank.

On July 24, we established a short position in November crude oil then trading at around 2111 and placed stops at 2200, close only.

One new recommendation: buy October sugar at the market; place initial stops at 850, close only.

On July 29, we bought October sugar as per our Hotline Update of July 26, at around 9.29. Initial stops were placed at 850, close only.

Have a great long weekend.

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