FRIEDBERG'S

COMMODITY & CURRENCY COMMENTS

Friedberg Commodity Management Inc. Volume 13, No. 6 June 14, 1992

The obvious dangers of mercantilism

It is not enough that they are being threatened continuously with trade reprisals. Nor is their monthly public embarrassment sufficient. Like POWs' admissions and recantations in some Manchurian, North Vietnamese, or Iraqi prison, they are being forced to admit that their trade surplus is abominable, unpardonable, and the source of all evil.

Brainwashed in the manner of the Manchurian Candidate, they engage in self-flagellation: The Bank of Japan talks up the yen daily and when necessary (almost every day last week) buys dollars to keep market participants duly informed of its continuing interest in revaluation.

These exercises in self-flagellation grow all the more intense just before the release of sensation-seeking headlines heralding another "monstrous" increase in trade surplus. In May, the positive balance "soared" or "surged" 89% from a year earlier.

Never mind that their economy is in a free-fall. And never mind that as much as 73% of the $3.7 billion increase in the surplus came from a precipitous 13.3% fall in imports, underscoring the severity of the economic collapse (incidentally, *The Wall Street Journal*, in a classic understatement, reported that "last month's expansion in the surplus was *fuelled* (our italics) by a 4.1% increase in overall exports... overall imports fell 13.3%").

The fact of the matter is that Japan is heading into its worst post-war contraction. The recently released Tankan, or quarterly economic survey, showed that the percentage of manufacturing companies that predicted a worsening in business conditions outweigh by 24 percentage points the percentage of companies that said conditions would improve. This reading of minus 24% compares with the previous February reading of minus 5%. Non-manufacturing fell from +17% in February to +1% in May, compared with a +5% forecast. At its peak in 1989 the manufacturing index rose as high as 55%.

Despite the BOJ's forecast that the economy hit bottom (do they *really* believe it, or do they want to buy more time to finish puncturing the balloon?), the recovery is not likely any time soon.

For one thing, inventories as a percentage of sales continue to rise as manufacturers repeatedly fail to gauge accurately the weak state of domestic demand.

More importantly, the (cultural) reluctance of big business to lay off workers (Japan's unemployment rate remains the lowest in the OECD) coupled with the corporate sector's sharply higher borrowing costs anticipated on the refinancing of $97 billion of bonds-cum-warrants issues expiring before January 1994 should extend the present downtrend in corporate profits (see Chart 1). Virtually *guaranteeing* their collapse is the squeeze on profit margins caused by the rising yen.

All told, private capital expenditure, which in the past accounted for as much as one fifth of Japanese economic output, is slated to experience a dramatic contraction.

Even fiscal policy is no help. While the government is likely to run a small 1.3% of GDP deficit in 1992, the impact (fiscal impulse in the IMF jargon) of this deficit on the economy is actually contractionary to the tune of 0.3% of GDP. If, however, one measures the much broader general government fiscal balance, which includes Social Security transactions, Japan will actually run a *surplus* of 3% of GDP in 1992, and the fiscal impulse will be contractionary to the tune of 0.5% of GDP (see Chart 2).

But what about those fabled trade surpluses? In classical economic theory, trade surpluses and their broader current account surpluses are the result of falling domestic consumption/rising domestic savings. To a certain degree they cush-

In this issue

Contributions by Albert D. Friedberg, Dr. Steve H. Hanke, David B. Rothberg, Neil Reynolds, Daniel A. Gordon, and Michael D. Hart.

ion an economic decline and may even lead a slumping economy out of a recession.

Current account surpluses can also be, and often are, the *result* rather than the cause of savings outflows: In much the same way as a rise in domestic interest rates causes savings to increase/consumption to decrease, attractive *global* investment opportunities can move savings abroad from the domestic economy. This causes consumption to fall and leads to a current account surplus.

A new book by Dennis Encarnation, a professor at the Harvard Business School, adds a little *twist* to the above, logically correct, macroeconomic postulate and explains the *channel* by which trade surpluses follow capital outflows.

Japan's direct overseas investments set up *majority-owned* overseas subsidiaries, which logically tend to import supplies from their parents. An example of this is Honda's Ohio car plant, unlikely to have the authority to buy parts without first checking with the head office in Tokyo. Not necessarily the same can be said about Mazda's plant in Japan (24% owned by US car manufacturer Ford), which shows little compunction about buying parts locally.

The trade "imbalance" is, therefore, more a product of investment protectionism than trade protectionism. Clearly, investment liberalization in Japan (it climbed 56%, to $4.3 billion in the year to April, compared with Japan's direct overseas investments of $41.7 billion) should go a long way towards redressing the trade "imbalance" between Japan and the rest of the world.

As discussed above, the trade surplus/current account surplus results from falling domestic consumption, which allows for a reallocation of resources towards the tradeable sector. The surplus is a function of the drop in domestic consumption: The more severe the drop, the greater the savings domestic, the greater the current account surplus.

Japan's "soaring" current account surplus is indeed a measure of its present economic woes. As Chart 3 shows, during the boom years of 1986-89, its C/A surplus diminished sharply, to 1.25% of GDP from slightly above 4% of GDP. By way of contrast, the years 1981-85 encompassed a severe recession in Japan and, later, a powerful US boom, which attracted enormous amounts of global capital, producing thus a rise in Japanese savings and, consequently, an expansion of the current account surplus (to slightly over 4% of GDP from nearly a balanced position).

Despite sensationalist headlines, the IMF believes that Japan's current account surplus (now at approximately 2.5% of GDP) is peaking and will likely fall slightly into 1993. Their forecast is based on an optimistic assessment of the economy. But even if one disagreed with this forecast, it is unlikely that the surplus will exceed the 1986 peak.

Should the G-7 publicly humiliate Japan for its "trading prowess" or should it, instead, allow the market to take its own course? And what about the BOJ? Should it actively promote the revaluation of the yen as it has been doing, thus deepening the economic contraction (via its anticipated impact on less exports and more imports and, more importantly, via its squeeze on profits margins)?

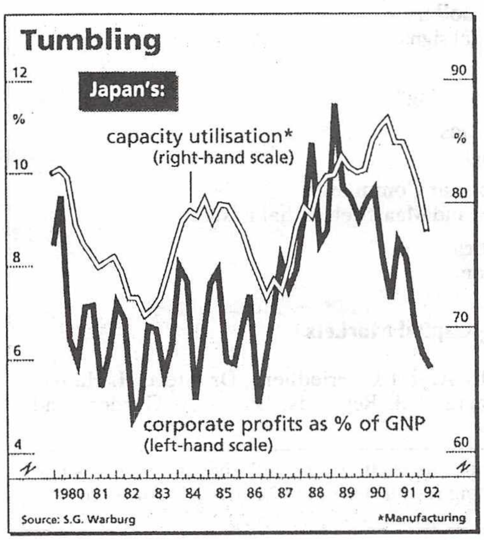
The recent 7% revaluation of the yen resembles one of history's great economic blunders: the UK's restoration, in 1925, of Sterling's pre-war parity, greatly overvaluing the currency (which led to a deeper depression than the one experienced by its neighbours). Then, the motive was prestige; today, a combination of fear (from the protectionist lobbies in the US and Europe) and sheer stupidity.

If the BOJ does not change course and allow the trade-weighted yen to depreciate 10% to 20%, it may truly bring about a depression.

STRATEGY: *A faulty exchange policy is likely to send stock prices much, much lower. Our first target, 9000-12000, is in sight.*

Sooner or later, the BOJ will recognize the error of its ways and will begin to promote a cheaper yen. The long DM/short yen cross has a "low" (political) downside (2%-3%?) and a great upside potential (10%-20%). Retain positions; lower stops to 77.00, basis spot, NY close only.

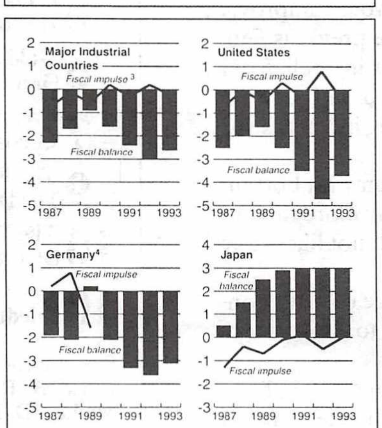
Chart 1



THE ECONOMIST

Chart 2

Chart Major Industrial Countries: General Government Fiscal Indicators[1]
(In percent of GDP) [2]

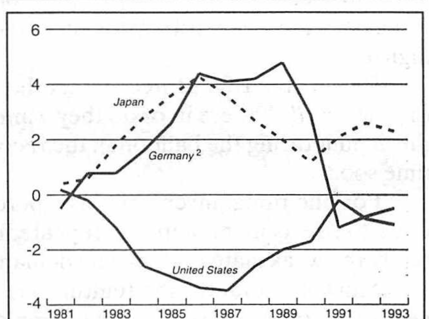


[1]Calendar years. A positive fiscal impulse indicates an expansionary policy. Shaded areas indicate staff projections.
[2]GNP for Germany and Japan.
[3]Excludes Germany after 1989.
[4]Data are for west Germany for 1987-90 and for unified Germany thereafter. Because of data problems associated with unification, the fiscal impulse is not calculated for 1990-93.

World Economic Outlook, International Monetary Fund

Chart 3

Chart Three Major Industrial Countries: Current Account Imbalances
(In percent of GNP)[1]



[1]GDP for the United States.
[2]Prior to July 1990, the current account balance of west Germany excluding the bilateral balance with east Germany; from July 1990, the current account balance of unified Germany. The shaded area indicates staff projections.

World Economic Outlook, International Monetary Fund

Chart 4 – CME Japanese Yen

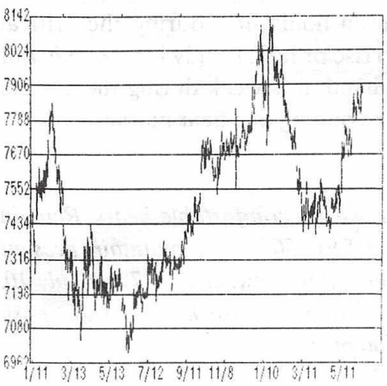


Chart 5 – NIKKEI Index (Cash)

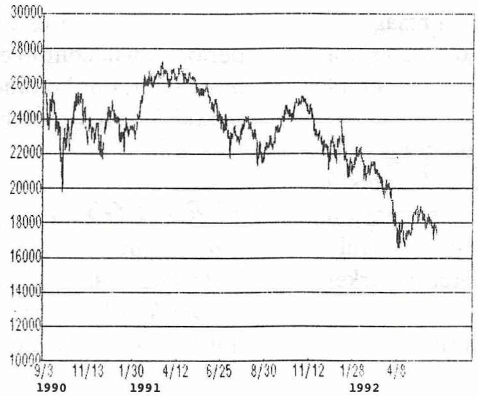
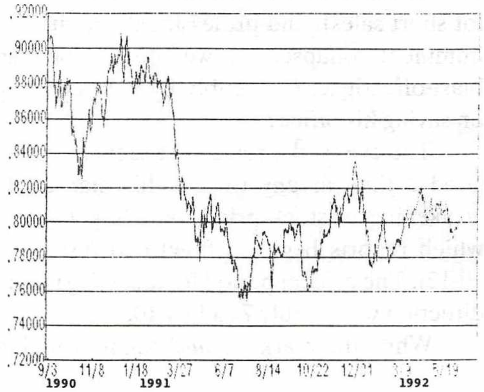


Chart 6 – DM/YEN Spot



DEUTSCHEMARKS/EUROMARKS

Waiting for the Bubba

Interest rate differentials *vis à vis* the deutschemark are inflicting intolerable pain on dollar bulls. But the Bubba won't let up. It must and it will seek tighter monetary conditions, lest Germany's inflation explodes. In past issues we have dealt extensively with this problem. Suffice it to say that the market is still not adequately forewarned or prepared for what is coming. As a result, we are still able to play the interest rate game with the deck stacked in our favor.

Cash three-month rates stand at 90.25; September '92 trades at 90.50 and December '92 at 90.77. You could sell these, and if rates remain unchanged, you make 25 and 50 points respectively — let alone the potential profit on a rise in rates. Alternatively, you could buy September '92 and December '92 at-the-money puts for *less* (17 and 24 points respectively) than the difference to cash rates. If rates remain unchanged, you win small. If they rise, as we expect, you win big. Sounds like "heads I win, tails you lose"?

STRATEGY: *Remain long deutschemarks; raise stops to 60.60, basis September '92. Remain short Euromarks and/or long the puts.*

Chart 7 – LIF Short Euromark Jun '92

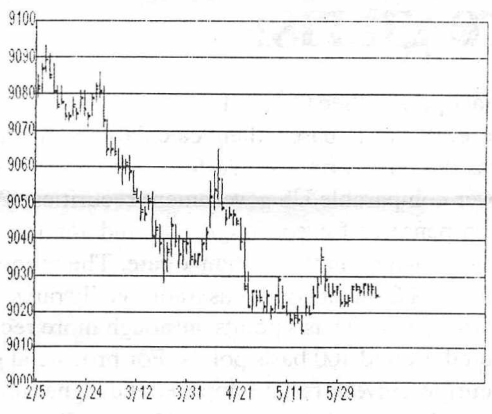
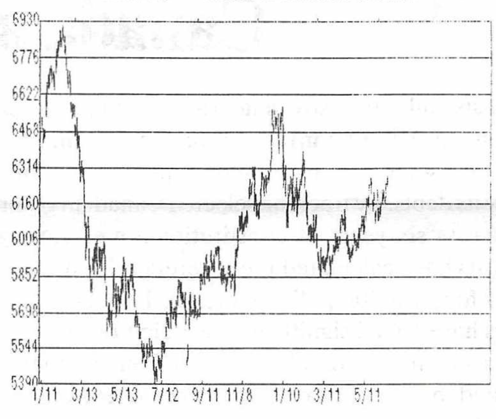


Chart 8 – CME Deutsche Mark



S&P 500

The boat is loaded

For the past five months, public buying of mutual funds has taken on an exponential character, averaging approximately $7.5 billion/month (see Chart 10, through December '91). The buyers are none other than the unlucky owners of maturing CDs, who are faced with having to accept rates as low as 3% p.a.. *Significantly* nearly all those buyers are under water, i.e., showing a loss (the broad market has gone nowhere, or perhaps slightly down, since early this year) especially after sales commissions and fees. How long before our hapless depositors realize that 3%, after all, is better than a capital loss?

While breadth numbers and the glaring Dow Industrials/Transportation non-confirmation continue to point to a massive distribution top, sentiment indicators (consensus, odd-lot short sales), and professional activity do not presage an imminent collapse. Are we going to be treated to one last blast-off, triggered possibly by a desperate president intent on saving his office?

The eve of the release of second-quarter earnings is as good a time as any to test this market: Logic dictates a weakening of stock prices *into* July 7 (the earliest date on which reports begin to flow) and *just past* that date (July 10-12). The critical period for *assessing* medium-term market direction will be July 7 to July 10.

While the market *could* begin dropping earlier (it usually does, as analysts receive more up-to-date information on the upcoming reports and they are determined to be disappointing), it *need* not do so. But regardless of its near-term direction, if it rises or even holds firm during the critical period, it will continue to rise or hold steady for a *number* of *months.* If, on the other hand, it is weak during the critical period, it may signal the beginning of a bear market.

STRATEGY: *Thus far, we are comfortable bears. Remain short futures and/or long S&P 500 puts; maintain present 419.50 stop. Assess market action between July 7 and July 10. Should it hold steady (and surely if it rises), cover short positions and liquidate S&P 500 puts.*

Chart 9 – CME S&P 500 Index Cash

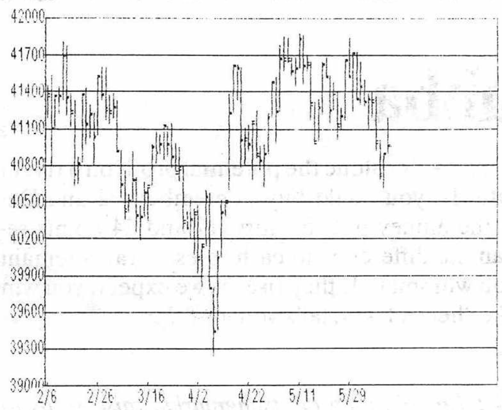
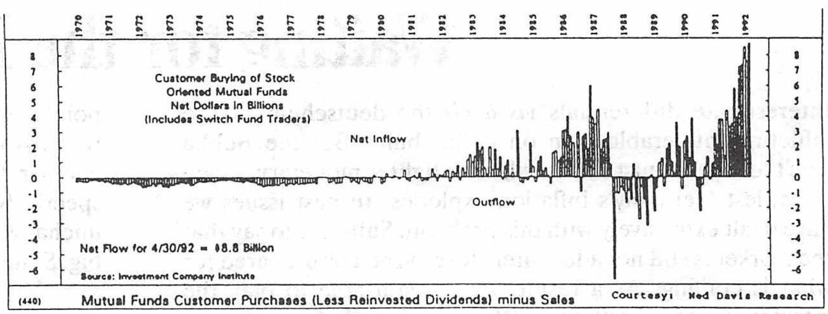


Chart 10



CANADA

Canada and sovereign risk

Economists call it the "sovereign risk premium" — the compensation extracted by investors for the risk that a government will do something extremely stupid and impair its ability to pay its debts. By tracking selected Canadian government bonds across six years of constitutional meanderings, two economists have calculated the sovereign risk premiums imposed by four specific political events. They concluded that investors have levied significant sovereign risk premiums on the government debt of all regions of Canada, that the premium paid by the provinces has increased, and that the sizeable differential appears permanent.

Paul Boothe (University of Alberta) and Richard Harris (Simon Fraser University) charted significant decreases in the sovereign risk premium on Canadian government securities: 1) after Pierre Trudeau emerged from retirement to viciously assault the Meech Lake constitutional proposals in 1987; 2) after the Conservative government won its free-trade election in 1988; and 3) after the Meech Lake Accord collapsed. They charted a significant increase in sovereign risk premium a few months later, when the Belanger-Campeau Commission began its post-Meech musings on Quebec's constitutional options. (See Chart 11)

The economists based their calculations on the yield premiums that are normally paid for Canadian government bonds over comparable US government securities. The premium compensates for sovereign risk and for the risk of unexpected changes in the exchange rate. The premium for Government of Canada bonds has traditionally ranged in the neighbourhood of 70 basis points, although more recently it has hovered around 100 basis points. For provincial government securities, investors have imposed the higher premium, with Ontario lowest and Newfoundland highest. Boothe-Harris isolated the sovereign risk premium, using US-pay bonds for Canada, Alberta, BC Hydro, Ontario, and Hydro Quebec, and contrasting them with a US Treasury bond of comparable maturity and coupon.

Why such hefty variances in differential? "The federal government, with its diversified sources of incomes, is viewed by investors as a less-risky borrower than the individual provinces," Boothe-Harris say. "And any change that reduces a government's ability to diversify its income will likely result in investors demanding a larger risk premium." In other words, Canada doesn't have to break up for risk premiums to rise; heated discussions of breakup can suffice; discussions of reforms that would actually keep the country together but that would reduce tax-collection options would suffice.

For all Canadian governments, the sovereign risk premiums are a significant cost, and will remain so throughout the months of murkiness between now and Canada's next constitutional arrangement. Boothe-Harris say that for a future 100 basis point rise in the risk premium, long-term annual debt service costs in Atlantic Canada would rise by $470 million; in Western Canada, by $1.25 billion; in Ontario, by $1.7 billion; in Quebec, by $1.5 billion. "Given the short term-to-maturity of much of this debt," they say, "these long-term impacts would be realized very rapidly."

With less tax collection diversification and flexibility than the Rest of Canada (ROC), Quebec can be expected to pay a proportionately steeper sovereign risk premium in the months ahead. This tendency is apparent in the Boothe-Harris chart. In 1986, the Hydro Quebec risk premium converged with the Canada risk premium; since then, the differential has become more dramatic and entrenched.

There is inherent and obvious risk in founding a new nation; there is inherent risk, also less obvious, in talking about it. And in the next four months, the talking will escalate in fervor and importance. On June 3, Bank of Canada Governor John Crow assured the world's leading bankers that Canada's constitutional troubles were having only a limited impact on Canada's markets and that they could not be considered "a crisis." He was right.

At this moment, investors' and citizens' attention is focused on the economy. But it would be inconceivable for Canada to emerge from the constitutional negotiations without some episodes of investor awareness and public alarm.

One definitive moment will be Monday, October 26, when Quebec poll-vaults into special status, sovereignty-association, separation — or something unexpectedly surreal, such as the status quo. Whatever the ROC does in the next four months, Quebec's autumn referendum will surely determine whether Canada remains a nation that stretches without breach from sea to sea. It will not end the negotiations; it will not end the country. It will be a decisive act of clarification.

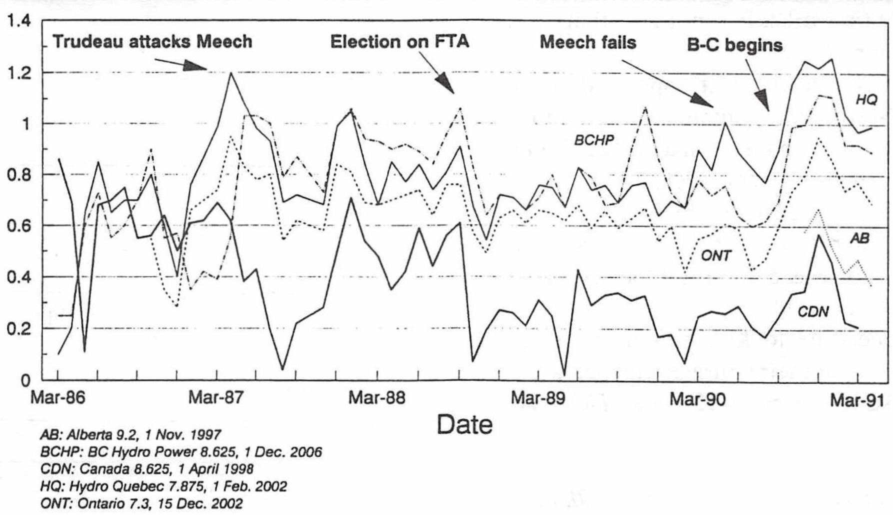
In the meantime, who knows what will happen? The federal government certainly doesn't. Will there be a federal referendum in September? We will know by the end of June. Will there be a federal-provincial first ministers' conference? Probably. Will Quebec's Premier Robert Bourassa attend? Probably not — it is still too early for the premier's return to the bargaining table. The federal government will, however, put together a "final offer," a doomsday document that will presumably compel Canadians to think seriously, one more time, about their future. There will be a major parliamentary debate. And Trudeau will (surely) speak once more.

Quebec, however, will be squeezed even more tightly between a ROC and a hard place. Part of the torque will come from the markets as an impartial assessment of sovereignty risk. Quebec is intelligently sensitive to the markets in a way that the ROC isn't, and Bourassa will not himself do anything stupid. But as Quebec economist Pierre Fortin has observed, Quebec understands the qualitative costs of a transition to sovereignty but does not know the quantitative costs. The markets will undoubtedly become more specific in quoting a price.

For readers interested in the economic consequences of Canada's constitutional negotiations, an excellent review is available from the John Deutsch Institute for the Study of Economic Policy at Queen's University in Kingston, Ontario. The two-volume work contains analysis from many of Canada's leading academic economists. Ask for *Economic Dimensions of Constitutional Change.*

By Neil Reynolds, former Editor of The Whig-Standard, *now a freelance writer, who will be covering the Canadian political scene and how it affects Canadian markets.*

Chart 11 – Premiums for US-pay bonds over US Treasuries



CANADIAN DOLLAR

Healthy vital signs

The Bank of Canada continues to accommodate a drop in short-term rates; differentials *vis à vis* US rates have narrowed to a new low, 185 basis points, basis three-month deposits.

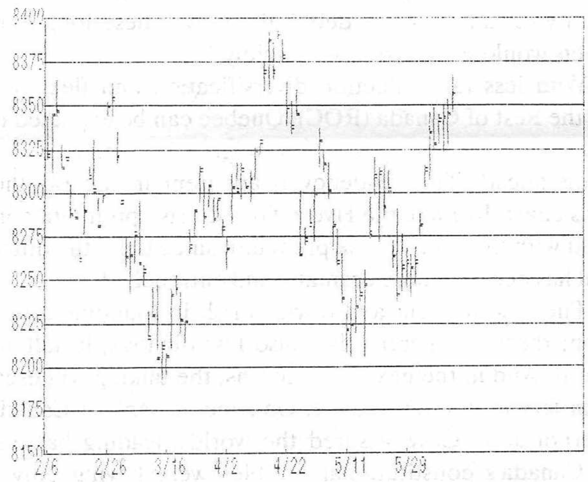
The monetary vital signs appear healthy: M2 is growing at an acceptable and moderate 5.7% year-over-year rate of growth, and consumer prices are running at least 1.5 percentage points lower than those in the US. The widening of the trade surplus led by a dynamic performance of exports confirms our gut feeling that the currency is not overvalued.

The lethargic constitutional debate has thus far had little or no effect on the Canadian dollar. Far more important was the successful floatation of a $2 billion Province of Ontario issue in the US. Its bullish impact on the Canadian dollar can hardly be denied. More future flotations and conversions should continue to underpin the currency.

As Mr. Reynolds has indicated in an accompanying article, concern over the state of the economy has pushed aside, at least temporarily, any serious concerns over constitutional talks. As we move closer to October 26, markets will increasingly begin to focus on the possibility of a break-up. Can it happen? And, if it did, would it be catastrophic?

***STRATEGY:** Watch the risk premium, and watch the currency. Market action will tell all. For now, remain long, compliments of Bob Rae. Stops at 82.00, basis September '92.*

Chart 12 – CME Can. Dollars Sep '92



GOLD

Fireworks coming?

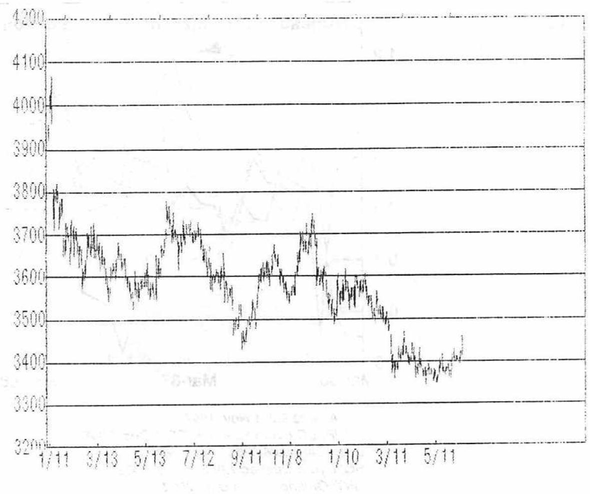
The strange quiet that descended over the bullion markets may presage some upside fireworks. Is it not true that "you never sell a dull market short?"

What can go well? For one thing, it appears that the mining community, ex Newmount Mining, is too complacent. For another, there seems to have been a fairly substantial amount of short covering in recent weeks (over 15,000 contracts). The intelligent manner with which this exit has occurred — prices were hardly disturbed — leads us to believe that a smart operator was behind it. Does he or do they know something that we don't?

It is true that producers are looking to sell into price spikes. But it is equally true that their courage will melt away should the spike look like it will cross $378/oz. *That* may produce the fireworks.

***STRATEGY:** You are long at approximately $342.50, basis August as per our Hotline Update of June 2.*

Chart 13 – Comex Gold



COMMODITIES

Weather markets

There is something about addressing the vagaries of weather that offends the sensibilities of people in the investment business. Speculating on the weather reminds me of the gamblers who hung around Spadina and College, my neighbourhood in the early '70s. We've invested too much money in our suits and our office furnishings, attempting to appear respectable to those whose confidence we would seduce, to allow such tawdry associations.

This year's weather, however, is, so to speak, just too much of a wild card to ignore. We are in the midst of an El Niño year, the 26th dating back to 1877. Furthermore, we should, this year, feel the full effects of the Mount Pinatubo eruption of last June in the Philippines.

Forecasting meteorologists use the same tools that actuaries, options writers, and virtually all odds-makers do. They apply standard deviation to historical events to determine a range of possibilities. The problem is that long-range forecasters come up with very high standard deviations (which means the predictions are imprecise). In addition, the event they are seeking to predict is not precisely quantifiable. In other words, while it is difficult to predict whether a drought will occur, say, in Northeast Africa six months from now, it is virtually impossible to predict the extent of the drought.

What we are going to do is apply the predictions made by two meteorologists we have followed — Atlas Forecasts and Earth Satellite Corporation — to cocoa and sugar. We will look to apply a synthesis of the meteorologists' calculations of the probabilities of adverse weather in key growing areas of each commodity, and then make our own predictions of the effect such adverse weather would have on prices, given our understanding of current fundamentals. We will not make any prediction of the extent of any adverse weather predicted.

Cocoa

On June 11, the cocoa market made a new 19-year low. The market's focus remains on arrivals from the Ivory Coast. That country, the world's largest producer, is obliged according to an agreement it has with the IMF, to sell two thirds of its production before the beginning of its next marketing year, which begins October 1.

Arrivals so far are estimated at 400,000 tonnes out of a harvest estimated at between 720,000 tonnes and 740,000 tonnes. The Ivory Coast has withheld the approximately 100,000 tonnes it must still offer to market according to the agreement in the hope of higher prices; the market, knowing the offerings must be made, is discounting values.

In our opinion, the market's focus on the Ivory Coast is myopic. Cocoa capacity, which was inspired by the bull market of the mid-'70s, has peaked in every major producing nation save in Indonesia.

This year's production, although above the expectations made earlier in the year by many bulls, will still be lower than the production of 1990-91; 2.3 mln. tonnes versus 2.5 mln. tonnes.

On the consumption side, despite the world recession and economic collapse in Eastern Europe, grindings, at approximately 2.4 mln tonnes, were at an all-time high.

Clearly the cocoa cycle has turned. The cycle of capacity expansion is over. Productivity rendered from existing capacity is diminishing as prices decline to levels at which it is no longer profitable to add inputs to crops. And consumption is increasing secularly as the prices of chocolate bars compete successfully on confectionary shelves. (Recently announced rebates by two large manufacturers and the emergence — albeit slow — from the recession will augment the trend).

Given these trends, we can reasonably expect a second consecutive production deficit next year based upon an increase in demand of approximately 4% (the seven-year average) and a production increase of less than 1%.

The resultant deficit of approximately 200,000 tonnes should draw stocks down to beneath 50% of usage. Furthermore, there is some talk that Brazil will seek to dispose of its 70,000 tonne buffer stock by donating it as a form of humanitarian aid to the CIS.

All of this is predicted without taking the weather into effect.

In the six El Niño years dating back to 1951, production declined every single year by an average 1.9%. El Niño-related weather is expected to impact upon four regions that together make up 79% of world production.

In the Ivory Coast/Ghana region, which constitutes 45% of production, dry weather is predicted from August through November. Unusually early and heavy rains through April have produced unusually early flowering of plants the effect of which will be to leave those plants especially vulnerable to pod rot disease should a drought occur.

North East Brazil, which produces 15% of the world's cocoa is also expected to experience dryness beginning now, in June. In Indonesia, where 16% of the world production is concentrated, flooding is expected.

Were production to decline by the El Niño average of 1.9% in 1992-93, the deficit would reach nearly 300,000 tonnes.

Prices would soar to at least $1,400/tonne — their average in nominal dollars given comparable ending stocks as a percentage of consumption figure.

STRATEGY: *Given the high correlation of production declines in El Niño years, and taking into account the market's misfocus upon the short-term situation in Ivory Coast, we find advantage in being net long. Our strategy at this point is to be buyers of December 1100 calls, currently offered at 25 and sellers of December 800 puts currently at 26.*

Sugar

As readers of these comments know, sugar fundamentals have been basically neutral all throughout the current 1991-92 season, which began last October 1. A small surplus of between 1 mln. and 2.5 mln tonnes has been predicted by statisticians throughout the season. A surplus in the predicted range leaves stocks as a percentage of consumption in the 30% range, the level considered by the industry to be the watershed of risk.

In December of last year the surplus was generally predicted toward the upper end of the range, in March it was predicted toward the lower end, and recently it has been again revised upward.

Despite the recent upward revision, sugar futures are currently trading at season highs. The July delivery is above 10¢. Technicians are hopeful.

Furthermore, we still lack accurate information regarding the size of beleaguered Cuban crop, which, if anything, is likely to be revised lower than higher.

At this point I am less than sanguine about price prospects for sugar. The market's strength is attributable to what seems to me to be a short-term dislocation only.

South African production was announced some months ago as being significantly damaged by the El Niño induced drought. That South African sugar was destined for sale to China and Japan. Trade houses have bid up the spot delivery to induce supplies from other origins. Since the most recent — upward — revisions to production estimates were made since news of the South African disaster was announced, it can be safely assumed those supplies will not be hard to come by at a later date.

Unlike cocoa there is no reason to assume the production/consumption balance will deteriorate next year. None, that is, except the weather and, perhaps, Cuba.

(A childhood friend who is a professor at the Waterloo University has invited me to join him on a trip to Cuba to visit a former student of his. The student is a staunch *Fidelista*. As a result, there is a chance, albeit a remote one, I may be able to learn something of the size of the crop. We leave Sunday, June 14 for a week. I'll keep you posted).

No precipitation anomalies are expected in Europe where beet production is expected to increase due to yields more in keeping with historical averages and as economies in the CIS and Eastern Europe start finding their legs.

The drought in Southern Africa has occurred and has already been discounted by current market action.

Finally, that part of the sugar universe most vulnerable to adverse weather — India, Thailand, Australia — is reported to be experiencing normal monsoon formation for the much needed wet season, which is beginning now.

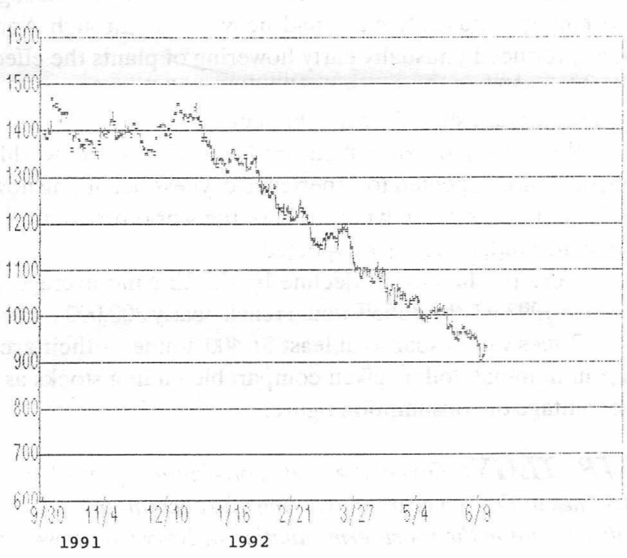
(Drought in these areas in years following El Niño years produced the bull markets of 1971 and 1982.)

In summary, staying long sugar now seems to me to be not just gambling on the weather but gambling in the worst way. It's like the old timers I used to see crawling into cars at the corner of Spadina and College to the racetrack at night. They owned great senses of humor, big hopes, and very poor odds. And they never had the money to buy a good suit.

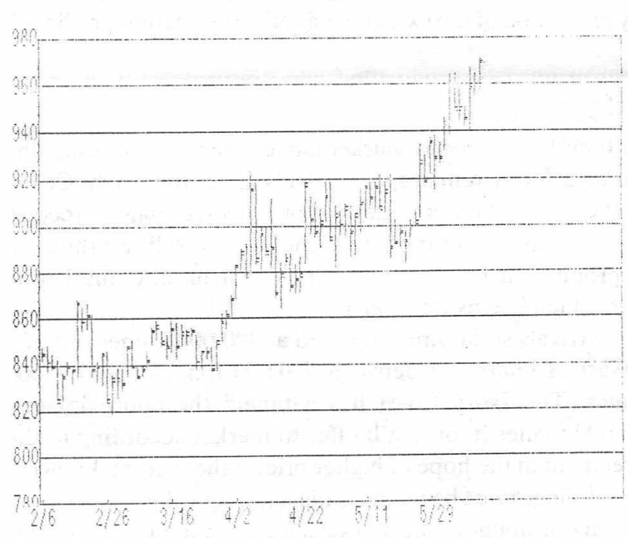
STRATEGY: *We would use the market's current strength as an opportunity to liquidate half our October calls.*

– David B. Rothberg

Chart 14
N.Y. Cocoa Dec '92



Chat 15
N.Y. #11 Sugar Oct '92



THE EUROPEAN COMMUNITY

The Danes and Maastricht: what next?

The Maastricht Treaty has always been a Pandora's box filled with wooden Trojan horses. The Danish rejection of the Treaty has opened the lid, and now all the horses are tumbling out of the box.

The Danish vote is remarkable. Like virtually all other EC governments, the Danish government has put its considerable weight on the lid of Pandora's box. Indeed, throughout the EC, there has been a tacit understanding amongst the politicians, media, and clerisy that Maastricht was too complex and too important to allow the people to interfere with its progress. In the Danish parliament, only the far left and far right (about 20%) were against the treaty.

Not surprisingly, therefore, the referendum propaganda campaign in Denmark was monopolized by the media and politicos telling people that Maastricht was good for them. But the Danes were dubious. A majority objected to being dragged into a centralized Eurostate and having their sovereignty submerged in a Brussels Eurosludge.

It is likely that the Danish government and its media chorus will suggest that the Danish people had a transitory aberration on June 2. Indeed, the proponents of Maastricht are already arguing that a new referendum should be held, after a decent interval, to allow the people to recover their senses and vote pro-Maastricht.

If that course is followed, it will be complicated if, in Ireland's referendum (mainly on the abortion issue), Maastricht is also rejected. Surely if these two Trojan horses emerge from Pandora's box, the Maastricht Treaty will be a dead duck.

As for monetary/fiscal policy, it is doubtful that the Maastricht rejection will have any substantial lasting effect on markets. Of course, we would expect the immediate shift of assets that were lured into the high-yield currencies to respond, in a Pavlovian way, to the news about Maastricht. But this immediate impact should soon wear off and even reverse.

Nothing of substance has changed. The Danes will remain in the ERM, and their short-term interest rates will continue to be controlled slightly above those of Germany.

Incidentally, Denmark, Luxembourg, and France are the only countries in the ERM whose inflation rates, long-term interest rates, fiscal deficits, and government debt levels are well enough behaved to allow them to qualify, at present, for membership in Maastricht's proposed monetary union. Hence, it's rather ironic that the Danes said "no, thank you."

The question arises as to whether the Danish vote has increased the likelihood of a realignment in the EMS. A little, perhaps, but not much. The capital movements due to the immediate portfolio shifts will cause some minor irritation, but nothing that cannot be readily handled by the central banks. The Danish rejection will not make the convergence of currencies and the establishment of a European Central Bank (ECB) and one currency noticably less likely. However, some portfolio holders do not believe this. They have been deluded by the Euro-rhetoric into believing that a treaty was necessary, even sufficient, for convergence.

What about convergence? With certain exceptions (notably Italy), the hard work (suffering) of pegging exchange rates and reducing inflation has already been done. Are the fruits of all these hardships to be thrown away, merely because of disagreements over some treaty about a far-in-the-future ECB and single currency? Most unlikely. Denmark remains more firmly in the deutschemark zone than any other country, save perhaps the Netherlands. There it will remain.

What about the ECB and a single ECU currency? The Germans will never give up their deutschemark and the Bundesbank. That was made clear to me in early February, when I discussed the matter in Davos, Switzerland with Dr. Hans Tietmeyer, Vice-President of the Bundesbank.

Moreover, provided Germany continues with its policy of low inflation, the ERM currencies will tie themselves every more tightly to the deutschemark. The Bundesbank will be the *de facto* central bank of Europe, and the DM its currency.

Incidentally, I suggested to Dr. Tietmeyer that the most logical (ideal) arrangement for Europe would be one in which the Bundesbank would be Europe's only central bank, with the other countries abolishing their central banks and replacing them with currency boards. Under such a currency board system, each country's board would issue a local currency that was backed 100% by deutschemark reserves, and each board's sole function would be to exchange its currency for deutschemarks at a fixed (not a pegged) exchange rate. With that setup, Germany would be the only country in the system with a discretionary monetary policy. Dr. Tietmeyer agreed wholeheartedly with my suggestion.

What of the effects on Italy, Spain, and other countries with "poor fundamentals"? (That is, relatively high inflation, large deficits, and poor prospects.)

The Danish rejection will have little or no discernable, persistent effects on interest rates in the countries with "poor fundamentals." Moreover, it is difficult to believe that the Danish rejection will have any substantial effects on financial markets either in the short, medium, or long run.

Pegging will continue and tighten over time, irrespective of whether there is a remote change, or no change, in the prospects for an ECB and one currency for Europe. Since little has changed, it is doubtful the predicted "flight to quality" will become pronounced. Politically, however, this wooden horse is a serious threat to the Delors-Maastricht (the socialist) plans for a highly centralized, corporatist union of Europe.

Indeed, inside the tummy of the Trojan horse we are beginning to hear the ordinary people of Europe urging defeat of the Brussels busybodies and asserting the sovereign rights of the peoples of Europe. June 2 was the day when Maastricht was sorely wounded. With the Irish bury it?

STRATEGY: *We continue to recommend Danish krone bonds, specifically Kingdom of Denmark 8%, 20/08/93, now yielding 9.41%. They continue to yield an attractive premium over comparable deutschemark bonds.*

– Dr. Steve H. Hanke

THE EXOTICS

Danish krone

It is ironic that the Danes rejected Maastricht when in fact they were the closest (next to the Netherlands) to achieving convergence of all OECD members. Anyway, their rejection of Maastricht has little to do with economics and a lot to do with Big Brother.

Calculated in terms of relative wage costs, competitiveness has improved by just under 20% since 1979. This has led to a sharp improvement in the trade and current balances. In 1990 Denmark recorded its first current account balance since 1963, and in 1991 the surplus almost doubled to Dkr14.2 billion.

Government finances have once again deteriorated after achieving slight surpluses in 1986 and 1987. For 1992, a deficit of Dkr36 billion is expected, down only slightly from the 1991 deficit of Dkr38.2 billion and equal to around 3.5% of GDP.

Denmark needs to institute some serious cuts in public expenditures to offset expected revenue losses, arising out of future tax harmonization within the European community and political pressure to reduce income tax rates.

Labor market rigidities are causing high unemployment and represent a significant fiscal burden. These too must be tackled in the near future.

STRATEGY: *The Danish krone is at the bottom of the EMS grid, and forwards provide approximately 1% per annum gain over dutschemarks. Thus, a long Danish krone/short DM spread is tentatively suggested. Profits should be accepted on any small improvement of their relative positions. Remain long krone* vis à vis *the US dollar.*

Chart 18 – Rates

Spot	1 Month	3 Month	6 Month	12 Month
6.0625 - 6.0675	6.0625 - 6.0675	6.1610 - 6.1670	6.2475 - 6.2655	6.3950 - 6.4175

FRIEDBERG CAPITAL MARKETS

Burnup & Sims, quarterly results

Revenues continued to fall in the quarter ended January 31, 1992. This decline can be attributed to weaker demand of large utility customers and to the loss of several contracts due to increased competition.

The company repurchased $2.6 million face value of its bonds in accordance with its sinking fund requirements, booking a profit of approximately $1.1 million. The 12% convertible subordinated debenture issue has been reduced to $29.75 million.

For the three-month period ending January 31, 1992, debt service of $1.147 million was covered 1.63 times, a vast improvement over the corresponding period of last year.

We offer the Burnup & Sims 12% of 2000, convertible bond priced to yield 17.36% — still attractive.

Recommended bond portfolio allocation for new portfolios

For new portfolios, we recommend the following investments:

Danish krone	45%
US dollar high-yield convertible bonds	20%
Canadian dollar bonds	20%
Argentina BICV	15%

Chart 19 – Foreign Currency Bonds

Date: June 11, 1992

WE OFFER THE FOLLOWING BONDS SUBJECT TO CHANGE WITHOUT PRIOR NOTICE:
MINIMUM US$5,000 (CDN.$7,000)

ISSUER/MATURITY DATE/COUPON	BID	OFFER	CURR.ANN. YLD.TO MTY.	NEXT PAYMENT DATE
DEUTSCHE MARK DENOMINATED				
KINGDOM OF SWEDEN 7 1/4% 1/2/95 call @ 100 1/2 in /93	96.15	96.90	8.59%	Feb.01
EUROPEAN INV. BANK 5 1/2% 9/08/93	96.45	97.20	8.14%	Aug.08
BANK OF NOVA SCOTIA 5 5/8% 07/05/96 RRSP eligible	90.15	90.90	8.46%	May 07
WORLD BANK 5 7/8% 4/02/97 RRSP eligible	91.65	92.40	7.88%	Feb.04
SWISS FRANC DENOMINATED BONDS				
GOVT. OF AUSTRALIA 5% 30/10/98	88½	90½	6.89%	Oct.30
DANISH KRONE DENOMINATED BONDS				
KINGDOM OF DENMARK 8% 20/08/93	97.70	98.45	9.41%	Aug.20
ECU DENOMINATED BONDS				
UNITED KINGDOM 9 1/8% 21/02/01	100 7/8	101 5/8	8.84%	Feb.21
BRITISH POUND DENOMINATED BONDS				
KGDM OF SWEDEN 9 3/8% 14/04/93	99 3/8	100 1/8	9.06%	Apr.14
FRENCH FRANC DENOMINATED BONDS				
EUROPEAN INV.BANK 8 3/4% 12/07/95	100¼	101	8.37%	Jul.12
CREDIT LYONNAISE 9 1/2% 23/12/96	100 3/4	101½	9.05%	Dec.23
JAPANESE YEN DENOMINATED BONDS				
GOVT. OF CANADA 23/7/93 5 5/8% RRSP eligible	100.85	101.60	4.10%	Jul.23
CANADIAN DOLLAR DENOMINATED BONDS				
ONTARIO HYDRO 10 7/8% 08/01/96 (semi annual)	108 3/4	109½	7.91%	JUL.08
GOVERNMENT OF CANADA (semi annual) 7% 06/12/93	100.60	101.30	6.15%	Jun.06
NEW ZEALAND DOLLAR DENOMINATED BONDS				
TOURIST HOTEL 0% 04/06/93	92¼	93¼	7.53%	4/6/93

ISSUER/MATURITY DATE/COUPON	BID	OFFER	CURR.ANN. YLD.TO MTY.	NEXT PAYMENT DATE
SOUTH AFRICAN RAND DENOMINATED BONDS				
ESCOM 11% 31/10/93 (semi)	95 3/4	96½	13.84%	OCT.30
AUSTRALIAN DOLLAR DENOMINATED BONDS				
COMMONWEALTH BANK OF AUSTRALIA 01/07/94 14%	111 3/8	112 3/8	7.24%	Jul.07
ARGENTINEAN PESO DENOMINATED BONDS				
ARGENTINA BIC V FIXED/FLOATING 1/05/2001 callable in full on any interest date	93.28	94.03	18.01%IRR	4th day of mth.
U.S. DOLLAR DENOMINATED FIXED CONV.BONDS				
PACIFIC SCIENTIFIC 7 3/4% 15/06/03 (semi) CV @$38 p/sh	87¼	89¼	9.55%	Jun.15
ALLIANT COMPUTER 7 1/4% 15/05/12 (semi) CV @$39.75 p/sh	7		n/a	NOV.15
COOPER CO'S 10 5/8% 01/03/05 (semi) CV @$27.45 p/sh callable in 1995	87½	90	12.56%	Sep.01
DICEON ELECTRONICS 5 1/2% 1/3/12 (semi) CV @$39.50 p/sh	35	37½	16.65%	Sep.01
BURNUP & SIMS 12% 15/11/00 (semi) CV @$16.79 p/sh	75¼	79¼	17.36%	15
U.S. DOLLAR DENOMINATED FIXED RATE BONDS				
FARM CREDIT CORP. 7 3/4% 10/06/96 RRSP eligible	104	104 3/4	6.36%	Jun.10
REPUBLIC OF ARGENTINA 7/10/93 11% (semi) 1 yr. put	104	104 3/4	7.23%	OCT.07

U.S. DOLLAR DENOMINATED FLOATING RATE NOTES	BID	OFFER	CURRENT COUPON	
UNITED KINGDOM 24/09/96 3 mo.LIBID-1/8 (qtly)*callable @ 100	99.91	100.21	4 1/16%	Jun.30
REPUBLIC OF ITALY 30.04/93 3 mo Limean (qtly)	99.70	100.10	4 1/16%	Jul.31

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

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

Chart 20
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, SAR, DKr, BP, FFr, Cdn, ECU, SAR, ARG) or revalue (JY) before the interest rate advantage/disadvantage is overcome by currency depreciation/appreciation. **Rates as of June 11, 1992.**

	U.S. $	NEW ZEALAND $	AUSTRALIAN $	DEUTSCHEMARK	SWISS FRANC	JAPANESE YEN	DANISH KRONE	BRITISH POUND	FRENCH FRANC	EUROPEAN CURRENCY UNIT	CANADIAN DOLLAR	SOUTH AFRICAN RAND**	ARGENTINEAN PESO
1 year	4.16%	Tourist Hotel '93 yields 7.53% (.5265 NZ/US)		EIB of '93 yields 8.14% (1.6378 US/DM)		Canada '93 yields 4.10% (126.33 US/JY)	Denmark 93, yields 9.41% (6.399 Dkr/US)	Sweden '93 yields 9.06% (1.7663 BP/US)				ESCOM '93 yields 13.84% (.2603 US/SAR)	
2 year	5.07%		CBA, '94, yields 7.24% (.7314 A$/US)										
3 year	5.60%			Sweden '95, yields 8.59% (1.7154 US/DM)									
4 year	6.07%			Bk. of Nova Scotia yields 8.46% (1.7246 US/DM)					Credit Lyonaise '96 yields 9.05% (5.936 Ffr/US)		Ontario Hydro '96 yields 7.91% (1.2774 US/CD)		
5 year	6.55%			*World Bank '97 yields 7.88% (1.6785 US/DM)									
6 year	6.75%				Australia '98, yields 6.89% (1.4413 US/SF)								
9 year	7.19%									U.K. 2001 yields 8.84% (1.1313 ECU/US)			***BIC V '01 yields 18.00% (.4247 $/ARG)
Spot Exchange Rate	N/A	.5435	.7619	1.5775	1.4302	126.40	6.0925	1.8495	5.3135	1.2984	1.1925	.2840	.990

*For example, since a US$-based investor would receive 133 basis points (788-655) by holding the World Bank DM bond, the DM can depreciate to 1.6785 US/DM from the present spot exchange rate of 1.5775 US/DM over the next 5 years for the DM investment to break even with current US$ 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.

***Yield in this case is a determined internal rate of return.

FOREX RATES & UPDATE

Currency	Spot	3-Month	12-Month	Comments vis à vis US$	Comments vis à vis DM (Spot DM: 1.5725)
Australian dollar	.7588-.7593	.7544-.7552	.7468-.7493	Remain short	Remain short
Belgian franc	32.34-32.38	32.78-32.85	33.84-33.08	Remain long	Neutral
Dutch guilder	1.7715-1.7725	1.7966-1.7979	1.8557-1.8581	Remain long	Neutral
*Finnish markka	4.2860-4.2880	4.3870-4.3920	4.6545-4.6665	Remain long	Sell
Greek drachma	192.15-192.20	198.75-200.80	221.65-225.90	Neutral	Neutral
Hong Kong dollar	7.7305-7.7315	7.7235-7.7280	7.7330-7.7440	Neutral	Neutral
Irish punt	1.6777-1.6787	1.6515-1.6545	1.5905-1.5990	Remain long	Neutral
Italian lira	1190-1192	1217-1220	1289-1294	Remain long	Neutral
Malaysian ringgit	2.5150-2.5170	2.5390-2.5530	2.5650-2.6350	Neutral	Neutral
New Zealand dollar	.5430-.5440	.5393-.5407	.5310-.5340	Neutral	Neutral
Norwegian krone	6.1480-6.1530	6.2435-6.2535	6.4780-6.5005	Remain long	Neutral
Portugese escudo	130.40-130.60	134.00-134.90	142.90-145.10	Remain long	Remain long
Singapore dollar	1.6210-1.6220	1.6180-1.6215	1.6110-1.6220	Neutral	Neutral
Spanish peseta	99.28-99.58	101.43-101.78	107.13-107.63	Remain long	Remain long
Swedish krona	5.6775-5.6825	5.7865-5.7960	6.0660-6.0860	Remain long	Neutral

Explanatory Notes

*Indicates change in recommendation from last issue.

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

HOTLINE UPDATE

Tuesday, May 19:
There are no changes or new recommendations.

Friday, May 22:
There are no changes or new recommendations. The market letter has been mailed.

Friday, May 29:
There are no changes or new recommendations.

Tuesday, June 2:
There is one new recommendations to buy August gold at the market. Place stops at 336, close only.

Friday, June 5:
This is a review of recommendations for the week. We brought August gold at approximately $342.50 as per our recommendation of Tuesday, June 2, placing stops at 336, close only. There are no other changes or new recommendations.

Tuesday, June 9:
There is one new recommendation: Buy September Canadian dollar at the market. Place initial stop at 82.00, close only.

Friday, June 12:
This is a complete summary since our last market letter, dated May 18, or all liquidations of open positions and new recommendations that remain outstanding.

On Tuesday, June 2, we bought August gold at approximately 342.50, placing stops at 336, close only. On Tuesday, June 9, we bought September Canadian dollar at approximately 83.30, placing initial stop at 82.00, close only.

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

Trading and Managed Accounts
All enquiries concerning trading accounts should be directed to:

In Canada
Friedberg Mercantile Group
347 Bay Street
Toronto, Ontario M5H 2R7
(416) 364-2700

In U.S.
Friedberg Mercantile Group Inc.
67 Wall St., Suite 1901
New York, N.Y. 10005
(212) 943-5300