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Paradise lost: On the decline of Europe and what it means for the dollar

On Sept. 20, in a national referendum, French voters will be given a choice to ratify the treaty on European integration initially agreed at Maastricht. They are damned if they approve it, and damned if they don't.

Designed by super-bureaucrats, Maastricht will superimpose a new layer of government upon the community's already bewildering maze of laws and regulations. In a recent letter to the Editor of *The Financial Times*, a correspondent writes:

"In the UK, he will be able to ignore some of the employment-related rules agreed by the 10, but he will have to comply with the new objectives. In Denmark, he will have to comply with Community law as it is at present, but he can ignore the new objectives. In Sweden, Switzerland or the other EFTA countries, he will also have to obey existing Community law, without the new objectives, under the EEA Agreement, but reliance on Community law will be more precarious because there will be no common court to enforce it. In Czechoslovakia, Hungary and Poland he will have to obey the parts of Community law which are embodied in the three Association Agreements.

"These extra layers of Community law will be in addition to the burden of complying with local national laws. One could hardly blame the businessman for staying at home: he will need a battery of lawyers to advise him every time he strays abroad. For whose benefit were the Community and its single market conceived?"

The vote on Maastricht comes at a most inopportune time. If approved by the community members, it will (perhaps?) buy short-term relief for the enormous strains in the European Monetary System (at this writing, the lire is being devalued by approximately 7% in a *quid pro quo* to match lower German interest rates). As against that, another bout of economic sclerosis will ensue. Superimposed upon a developing cyclical correction, Eurosclerosis will guarantee an already high and rising level of unemployment through Western Europe.

European prospects become downright catastrophic if we take into account the hundreds of thousands of war refugees from the disintegrating Balkans and the millions of economic refugees fleeing Eastern Europe. Literally next

door, Russia is drifting into economic fascism as hyperinflation pits its military-industrial complex against a weak and largely ineffectual government vainly intent on implementing a program of economic reform.

The West European cyclical decline is gathering momentum. Second quarter German GDP figures showed a drop of 0.5% against the previous quarter and only a small 0.6% gain against the same period last year. Led by weakness in industry orders, industrial production declined by 2% in the three months ending in June. The quarter to quarter change in retail sales plunged further into negative territory for the first time since the 1982 recession, an indication that the reunification boom, which saw quarterly changes rise as high as +13%, is history.

The collapse in East German industrial production is proceeding apace: The key engineering sector, badly hit by the fall in trade with Eastern Europe, was producing in May just 25% of its monthly output for the second half of 1990. It speaks volumes about Germany and about its East European trading partners. Rapidly rising unemployment in Sweden, Finland, Norway, Spain, UK, and Italy are dampening consumer spending and spreading economic contraction via

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falling imports to the rest of Europe. In a classic beggar-thy-neighbour outcome (and surely unintended) the cheap US dollar stops the contagion from spreading to the US, and it worsens the European plight.

How will this temporary and not-so-temporary (if Maastricht is approved) European stagnation/depression affect foreign exchange markets? Not so long ago, theorists and traders followed trade and current account figures for clues to future currency behavior: Surpluses were thought to be the product of a cheap currency and thus denoted some degree of undervaluation. The opposite was true for deficits. This theory lost its value during the '80s and, rightly, was substituted for one that best projected capital flows.

In fact, quick-(or quicker)-to-react capital flows would set currency rates, which in turn would affect trade flows and patterns. And while it may have appeared to be a case of the tail wagging the dog, it was not quite so: Efficient asset markets react at the touch of a button (on the Reuters terminals), goods markets must undergo a painful adjustment that may involve reallocating capital and labor. *Ex-ante* the demand for the desired currency overwhelms its supply; *ex-post*, demand and supply are equal, but at a sharply revalued level (in a floating regime).

So far, so good. But what causes these capital flows? Expected rates of return, which includes a long list of factors: real competitiveness; tax rates; political stability; the "friendliness" of government policies; monetary policy; and so on. *Not* interest rate differentials, because these are merely a function of the market's expectations of future appreciation/depreciation. Nevertheless, if you could be sure that exchange rates would remain fixed, you could lend with impunity in a high interest rate currency and borrow with equal impunity in a low-interest rate currency. In fact, this is the way the old gold standard worked, and this is the way fixed-rate regimes like the European Monetary System still work: It requires supreme confidence in the stability of the parities. Central banks losing reserves would regain them by lifting interest rates at the expense of other central banks.

What was applicable to fixed rate regimes was not necessarily applicable to floating rate systems. (Substantially) efficient markets would not permit one to arbitrage interest rates with impunity. If we hedge the risk in the forward market, we gain nothing. If we don't, we expose ourselves to currency changes that could wipe out our interest advantage.

A case in point. Starting in January 1990, Euro-DM interest rates began to gain in Eurodollars, i.e., the spread became positive. Since then, more than 35 months have elapsed in which German interest rates are higher — and have gained almost uninterruptedly — than US rates. And yet, the DM/\$ rate has not been exactly a joy-ride; at one point (mid-1991) the rising US dollar all but wiped out the accumulated interest rate advantage. Admittedly, of tonight's levels (DM 1.50/\$), the DM has indeed gained somewhat on the US (at a "cost" of 650 basis points interest differential) during this period. What is more, even if it had not risen against the US dollar, it has provided a superior overall return when

account is taken of the higher yield.

If markets were relatively efficient (and we believe that they are, although not strongly so, especially in the short run), this DM ride is a unique and rare occurrence: High yield currencies normally tend to depreciate at least as much as the yield advantage.

Interest rate differentials are obvious, for-all-to-see, economic variables. As such, they are not likely to be good predictors of currency rates. Why? Simply stated, there must be a reason why they exist, and one market (foreign exchange) *should* not be smarter than the other one (money market): They are both part of the asset market.

Is there a more reliable variable, one that could generate better forecasts of future capital and thus currency movements and that is not as obvious as interest rate differentials? We believe that there is: relative economic performance. Its most important manifestations are economic growth and corporate (and non-corporate) profits.

Historically, growth differentials and currency rates correlate very well. The problem is *predicting this growth differential*. In the spring and summer of '91, market participants came to believe that the US was heading for a strong recovery, while West Germany was in the throes of a slowdown and future recession. This widely-held belief caused a sharp 27% rise in the US dollar. The convergence did not materialize immediately, and the US dollar fell back recently to new lows.

It may appear that we have accomplished little, for we merely substituted one unknown (growth differential) for another one (future currency direction). Possibly. But there are times, such as now, when a certain degree of confidence can be gained (at least to our intuitive way of thinking) on future *relative* economic activity: For the reasons stated above (and the article that follows on the US economy), we predict that relative to the US, Europe's rate of economic activity will decline.

Ergo, the dollar is bottoming.

Intuitively, we have arrived at a forecast of relative economic activity. Can we do the same for *expected* rates of return and profits? *Very* approximately and *very* tentatively, we believe we can.

It means examining dividend yields. To overcome varying accounting treatments across borders, and once-off writeoffs, we have chosen dividend yields over earnings yields. Everything else being equal (and it almost never is), investors will pay high prices for securities and thus obtain low dividend yields if they thought that *future* profits and dividends would rise. Conversely, investors would *demand* high dividend yields in the present as a protection for falling future profits and dividends.

While one could argue that interest rate levels affect stock prices, it is unlikely that short-term rates would have more than just a passing influence. If we could observe, over a period of time, rising dividend yields, we could surmise that investors were betting on lower *future* returns on capital. This is, in fact, what is happening in European markets where our composite dividend yield index (see Chart 1) has risen from

3.47% to 3.95% since mid-April. Conversely, in the US, dividend yields, at 3.0%, have remained unchanged. Here, we must assume that markets expect no change in rates of return. Our earlier point is being substantiated: Investors expect a better profit climate in the US than in Europe.

Summing it up, currencies follow the path of profits and better relative economic performance. Recession in Western Europe is spreading with the downturn in Germany; the US,

on the other hand (more on that in the next article), protected by an extremely cheap currency, continues on a recovery path. We conclude that the US dollar has bottomed and will soon enter a lasting appreciation.

STRATEGY: *We managed to take long dollar positions early Friday morning (see Flash Update) at around DM1.4375/\$. Remain long dollars until further notice.*

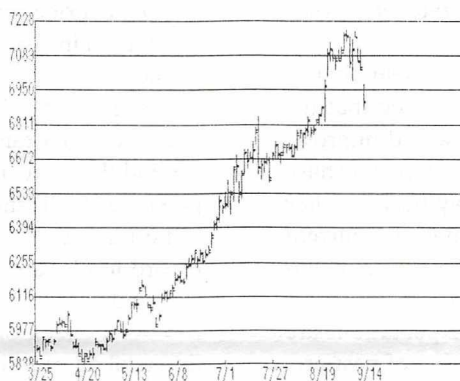
Dividend Yields

	4/13/92*	9/10/92*	1990 GNP	EX RATE 1990 AVG	1990 GNP IN USD	% TO TOTAL	ADJUSTED 4/13/92 %	DIV YIELD** 9/10/92 %
AUSTRIA	2.05	2.57	1,778,000	11.3700	156,376	0.0237	0.05	0.06
BELGIUM	5.32	5.94	6,521,000	33.4180	195,134	0.0296	0.16	0.18
DENMARK	1.85	1.78	767,400	6.1890	123,994	0.0188	0.03	0.03
FRANCE	3.39	3.65	6,492,000	5.4453	1,192,221	0.1807	0.61	0.66
GERMANY	2.26	2.66	2,428,900	1.6157	1,503,311	0.2279	0.51	0.61
IRELAND	3.73	4.53	22,911	1.6585	37,998	0.0058	0.02	0.03
ITALY	3.55	4.31	1,291,480,000	1198.1000	1,077,940	0.1634	0.58	0.70
NETHERLAND	4.32	4.70	509,000	1.8209	279,532	0.0424	0.18	0.20
NORWAY	1.77	2.23	644,610	6.2597	102,978	0.0156	0.03	0.03
SPAIN	5.20	6.20	49,627,000	101.9300	486,873	0.0738	0.38	0.46
SWEDEN	2.82	3.17	1,302,560	5.9188	220,072	0.0334	0.09	0.11
SWITZERLAND	2.32	2.38	326,100	1.3892	234,739	0.0356	0.08	0.08
UNITED KINGDOM	4.86	5.39	552,660	1.7847	986,332	0.1495	0.73	0.81
EUROPEAN MARKETS (COMPOSITE)					6,597,502		<u>3.47</u>	<u>3.95</u>
USA	2.98	2.97					<u>2.98</u>	<u>2.97</u>

* Gross Dividend Yields; FT-Actuaries World Indices.
** Weighted by relative GNP.

Chart 1

Chart 2 - CME DEUTSCHE MARK SEP '92



THE ECONOMY

Two cheers for the recovery

In "Resiliency Lost" (see our March issue), we presented an extended analysis in which we concluded that the cyclical recovery in the US was firmly in place, but that it would be muted because of secular considerations. Our analysis and forecast put us at odds with most observers who indicated back in March that by the end of 1992, the cyclical recovery would be well underway. Indeed, those optimists were calling for year-over-year growth rates in the 3% to 5% range by the close of 1992. Recall that we were calling for a comparable

growth rate of something less than 2%.

As we move closer to the end of the year, it appears that our analysis and forecast will be validated and that the optimists will be proven incorrect. Indeed, most of the optimists have thrown in the towel, and have become confused and pessimistic.

Given the importance of our analytical insight, it merits a restatement and refinement. The recent recession was unique. During the typical recession, most of the GNP short-

fall (about two-thirds) is accounted for by reductions in investment. Reduced consumption, on the other hand, typically accounts for only about 25% of the shortfall, even though consumption is almost two thirds of GNP. In consequence, as short-term rates fall and the yield curve becomes positively sloped towards the end of a typical recession, investment is stimulated, and the economy rapidly bounces back.

During the recent slowdown, the picture has been atypical. For example, the drop in consumption has accounted for 54% of the shortfall of real GNP from its average growth, while the drop in investment has accounted for only 38% of the decline. That picture looks like the one depicting the Great Depression, when the consumption decline accounted for 50%.

To understand the significance of the atypical pattern, we have to look at an insight developed in the late 1950s by Professor Milton Friedman: *the permanent income hypothesis*. That hypothesis states that people make consumption decisions based on the income they expect to receive over their lifetimes (permanent income), rather than on their current or transitory income. In consequence, if people think their income is falling due to a short-term slowdown in the economy, they will not reduce their consumption too much. Instead, they will use their savings or borrow to maintain their consumption, rather than drastically cut back their consumption. However, the permanent income hypothesis states that people will scale back their consumption sharply if they expect the decline in their income or the rate of income growth to be long lasting (permanent).

Given Professor Friedman's insight, it is clear that in typical postwar recessions, people had confidence that the slowdowns were temporary and that things would improve. However, that is not the present picture. Indeed, people have cut back on consumption in an unusual way because they have little confidence in the future; they think the current slowdown will have permanence and that the economy has lost its resilience. Their conclusion is based on past long-term trends in productivity. (That is, their expectations are autoregressive; future productivity is a function of past productivity.) It is also based on the fact that neither US political party is proposing a market-friendly set of pro-growth economic policies. Hence, people have cut back hard on current consumption; they correctly have less confidence in the future than at any time since World War II.

* * * * *

Our analysis about the permanent income hypothesis suggests that secular considerations are negative and will act to mute a normal cyclic recovery in the US. That said, we must now focus on the positive. First, our old reliable supply-side spread, which we introduced in November 1987 ("Supply-Side Spreads Signal Boom"), are signalling a solid recovery (see Chart A). Indeed those spreads indicates that the real side of the economy is showing some strength; economic expansion will be rewarded by profits.

For our second piece of data about the prospects for the recovery, we look at indicators from the financial markets. To do that, we revisit the pioneering theory of Professor Irving Fisher (1867-1947), who was described by Professor Joseph Schumpeter as America's greatest scientific economist. Professor Fisher suggested that investors receive more benefit from a dollar when their consumption levels are "low" (during a slowdown or recession) than from a dollar when their consumption levels are "high" (during the peak of a business cycle). In consequence, if investors anticipate an economic downturn, they will tend to sacrifice current income (during "good" times) in exchange for future income (during "bad" times). In other words, during good times, investors will tend to invest in assets that will provide insurance for an expected downturn in the economy.

This investment hedging behavior is intended to allow investors to smooth their consumption over time. It also implies that in anticipation of an economic slowdown, for example, investors will tend to sell some of their short-term bonds and substitute longer-term bonds that will generate income during an anticipated economic slowdown (and vice versa). This will cause the price for short-term bonds to be bid down, which will cause their yields to rise, and the price for longer-term bonds to be bid up, which will cause their yields to fall. In other words, an anticipated economic downturn will cause a "normal," positively-sloped yield curve to become flatter or invert. Just how much substitution between short-term and long-term bonds take place (the magnitude of the bond price and yield movements) will depend on the strength of investors' expectations about the future course of the economy.

So much for the theory. Do the data support it? Yes, they do. When, for example, short-term rates are below long rates, we find that with about a five-quarter lag, economic activity picks up. Well, short rates have been below long rates for some time, and that yield spread remains positive, at near record levels (about 400 basis points). Yield spreads, therefore, indicate a strong cyclic recovery.

As a check on yield spreads, we must look at another financial market indicator: default risk premiums. Those premiums are a good indicator of investor confidence. When default premiums are high (measured by BAA-rated corporate paper minus 30-year yields on US Treasury securities), investors have little confidence and vice versa. As Chart B shows, default risk premiums are at historic lows. Even though consumers have deep reservations about the future, investors have little concern about default risk. Indeed, they are optimistic about the cyclic recovery.

IMPLICATIONS: *Supply-side spreads and financial market indicators suggest a strong cyclic recovery. Secular considerations suggest that the recovery will be muted, however. Hence, let's give two cheers for a muted, but solid, recovery.*

– Dr. Steve H. Hanke

Chart A
SUPPLY-SIDE SPREADS

	Spreads
1991.1	- 1.5
91.2	- 2.0
91.3	+ 0.1
91.4	+ 1.4
1992.1	+ 3.2
92.2	+ 4.2

NOTE: Supply-Side Spread = Output per hour + Deflator - Unit Labor Cost. The spread is a proxy for profitability in the non-farm business sector of the economy. A negative number signals a lack of profitability and contraction in economic activity; whereas, a positive number signals profitability and an economic expansion.

Chart B



CANADA

Oh, Oh, Canada

For Canadians, it's going to be the shotgun marriage of the century. But will it be one bride for seven brothers or one bride for 10 brothers? Will the ceremony proceed without all of the grooms? Is this a holy act of matrimony or a wedding of convenience? The marriage contract is suspect. How many guests will object? On Monday, Oct. 26, Canadians must decide whether to speak or hold their peace.

Prime Minister Mulroney has defined Canada's national referendum on the terms of constitutional "renewal" in the simplest way: If you love Canada, you will vote "yes." But he waved the shotgun before putting it back behind the door: If you vote "no," you are an Enemy of Canada. The stag party will be rough. For investors, though, a love match isn't necessary. The only question is, Will the ceremony take place or won't it?

Like the Maastricht treaty in Europe, Canada's draft agreement on constitutional reform needs an audible "yes" from all members of the family. Canada's 10 premiers have endorsed it; all three of Canada's national political parties have endorsed it. With the financial resources of every government in Canada committed to it, the "yes men" look invincible. Further, a national "no" team does not exist, at least not in any organized, coordinated way. Yet the question remains: How much "Danish dissent" is out there?

In its entirety, the agreement requires the blessing of separate majorities in all 10 provinces (10 brothers). The provisions for an elected Senate, for example, require 10 "yesses." Lesser parts of the agreement, though, need only seven "yesses (seven brothers), provided that Ontario and Quebec (Big Brothers) are among them. And the referendum itself is not binding; a provincial legislature could, if it wished, approve the accord after its residents had repudiated it. This, though, is not apt to happen. If a single province withholds its approval, the accord will evaporate into the autumn air.

Through two years of prenuptial negotiations, the markets — though nervous — have obviously assumed an acceptable conclusion; on Aug. 28, they thought that they had gotten it. And public opinion polls quickly put "yes" sentiment at 60%. But back-to-school week produced a disquieting moment of reflection. On Sept. 8-9, money markets spooked; the dollar fell 1.1¢; 20-year Canada bonds fell by 90¢; ominous warnings of "a full-fledged Canadian currency crisis" appeared, out of nowhere, in the financial pages.

Whether or not Canada's constitutional turmoil caused the markets to panic, whether or not it was even a factor, people assumed a connection. And perhaps rightly. The break in the market followed by a day or two, or by hours, these developments:

1) Quebec disarmed itself. With its own mandated referendum on sovereignty long scheduled for Oct. 26, Quebec had negotiated with a knife to Canada's throat. (If an explicit threat of sovereignty wouldn't get Canada's attention, what would?) On Sept. 8, Quebec Premier Robert Bourassa discarded the sovereignty option for a referendum on the national accord. Ironically, the alteration gave Canada a risk-free option; it could repudiate the accord without endorsing the break-up of the country.

2) On Sept. 7-8, Mr. Bourassa declared — and repeated his declaration — that Quebec would regard approval of the agreement as a first step toward Quebec's real constitutional objectives. ("I concede," Mr. Bourassa said, "that we have not achieved all of our objectives.") Whatever his intent, he appeared to diminish the importance of the accord and the referendum. Perhaps a "yes" decision would not end the bickering after all.

3) On Sept. 8, 47 days before the referendum, Alberta Premier Don Getty announced his resignation. Mr. Getty

will campaign for the accord, but the fade-back stratagem of this one-time professional football player gave the Alberta-based Reform Party, which opposes the accord, an open running field.

By Sept. 10-11, the markets relaxed. The country's pollsters were reporting that "yes" sentiment remained strong. New York financial analysts were advising clients that "yes" would prevail. The campaign, however, has yet to be fought. Will we get 10 neat "yesses," all in a row? Remain sceptical.

For one thing, public opinion polls may exaggerate "yes" sentiment. Few people are eager to confess over the telephone that, no, they don't love Canada, that they are Enemies of Canada. And "no" sentiment appears to have a growth potential that "yes" sentiment doesn't.

If a deceptive optimism prevails during the campaign, a contrarian decision in a single province on Oct. 26 could thoroughly rattle investors abroad. The markets have already reduced the sovereign risk premium on Canadian bonds to its lowest level in years, the Sept. 8-9 reversal notwithstanding; a sharp, dramatic (though temporary) rise in risk premium would no doubt occur.

Which provinces might say "no"?

Quebec, obviously. The result in Quebec will be close, and a close "yes" could be as problematic as a close "no." Unless the accord gains 60% assent, it will have only marginal legitimacy; the separatist forces there will dismiss it as a result warped by Quebec's English-speaking minority. Quebec polls show that most "decided voters" would reject the accord. Voters who now have no opinion will decide the issue.

Alberta and Saskatchewan might say "no."

Many Albertans regard the accord as another Central Canada sting operation, which may explain Mr Getty's abrupt announcement. Defiant Albertans are already putting up Enemy of Canada signs on their doors.

As Alberta's neighbor, Saskatchewan might resist in sympathy with and support for the good folk next door; but people in Saskatchewan, more than elsewhere, resent the accord's violation of rep-by-pop. The accord promises Quebec more Commons seats than its population warrants. For starters, it antes up 36 more Commons seats for Ontario and Quebec, a gain for Central Canada that outweighs the 35 MPs now sent to Ottawa by Alberta and Saskatchewan. Further, Saskatchewan is in deep economic trouble; the public mood fluctuates between disgust and despair.

British Columbia might say "no." Premier Michael Harcourt consented to an erosion of B.C. strength in the Commons; and he announced that B.C. would guarantee women half of its Senate seats (as Ontario, New Brunswick, and Saskatchewan will). This double-dowry is highly controversial.

Newfoundland might say "no." This is where the ghost of Pierre Trudeau found refuge, where people still champion an omnipotent Ottawa. Quite rationally, measured by self-interest, Newfoundlanders distrust any change that might imperil the flow of federal transfer payments. Workers in Newfoundland can collect unemployment insurance payments

for 40 weeks a year — can work three months on and nine months off — and many of them do. The accord ensures that Ottawa will keep the money flowing, but Newfoundlanders are highly suspicious of all the talk about worker "mobility," which they regard as a form of expulsion from their island.

In fact, strictly on its own merits, the accord could probably not survive in any province. Where it does, it will be for two off-topic reasons: 1) many Canadians want a chance to prove that they do love their country; and 2) many Canadians are sick to death of the tedious squabbles, the endless bickering, in Canada's mismatched union. In other words, any mute, mail-order bride will do.

Can Canada hold its nose for six weeks without letting go? If Reform leader Preston Manning can oppose the accord without looking like a traitor, the "love-vote" may sink. If people begin to sense that the referendum is one step in a long, forced march, people may detour to the status quo for relief.

Unanimity is rare in any set of circumstances, whether in family life or national life. Ten affirmative decisions in 10 restive provinces will be much more difficult than many Canadians, and many investors, now appear to think.

* * * * *

The constitutional accord is politically vulnerable because it is, in its compromises, a compendium of contradictions. What it gives with one hand, it withdraws with the other. (Yes, we will have domestic free trade; no, we won't.) From this weakness, ironically, the agreement derives whatever strength it has. It is the Great Canadian Compromise. It is Canada's best effort at meeting everyone's minimum demands, at least symbolically. The fine print in the text gives Canada's competitive interest groups hope for eventual triumph in the courts.

In economic terms, the agreement would take Canada one small step forward, two giant steps back.

It would reduce the federal-provincial duplication in a number of entangled jurisdictions (culture, forestry, mining, tourism, etc.) — a positive reform.

At the same time, it would build a bigger trough for the dining pleasure of all the provinces that have grown dependent upon federal transfer payments. (Canada is the only country with a guaranteed income scheme for provinces rather than for people.)

How to pay the bill? Rust-bowl Ontario is Sugar Daddy for Canada's "welfare states." Sugar Daddy, though, has had a serious reversal of fortunes. Relative to its US competition, Ontario's productivity has fallen sharply, and its labor costs have risen precipitously. Expressed in US dollar terms, against a US base, Canadian labor costs have gone up 36% since 1986. In the same period, Canadian productivity growth has lagged US growth by 16%.

Ottawa has recognized the crisis that lies ahead. The provinces haven't, especially Ontario. Unfortunately, most economic analysis ignores the hinterlands, where big spenders anonymously toil away. (Provincial and local governments spend more than Ottawa spends.) Combine provincial

debt with federal debt: In 1990, it reached \$460 billion, or 70% of GDP. The percentage 10 years earlier: 37%. Ontario's massive deficits are pushing the percentage higher still.

The constitutional accord carries a serious cost. It puts East-West welfare payments ahead of North-South trade. It increases federal subsidies for provincial spending. Whatever you subsidize, you get more of it. Immediately ahead, we should expect higher provincial spending, and higher deficits. In this environment, Ottawa will have to choose between exceptionally painful restraint and a significant devaluation of the dollar. Some academic economists regard the devaluation, within the next three or four years, as inevitable.

In other words, the agreement is not apt to deliver the economic stability that the business community and the mar-

kets expect from it. Economics aside, it mandates a labyrinth of federal-provincial consultation, quasi-judicial tribunals, a score (or more) or new (native) governments, and an experimental Senate. We will have lots of talk; as the Chinese proverb puts it, talk doesn't cook rice.

The accord reflects the fear and trepidation of Canada's various regions; it is a manual for a social-welfare Maginot Line. Ideally, a constitution should mirror a people's faith, not a people's fear. It should articulate fundamental principles. This accord guarantees one of the world's most elaborate sets of safety nets, and promises that they will ultimately be replaced by hammocks.

– Neil Reynolds

CANADIAN DOLLAR

Bear market

Neil Reynold's analysis presented above makes it abundantly clear that political uncertainty regarding the future Canadian constitution has increased rather than diminished as we had earlier hoped for.

In common with Maastricht, a "yes" vote, in economic terms, may mean a small step forward and two gigantic steps backward. In the medium to long term, Canada is doomed to major losses in relative and even absolute productivity. What is distressing is that even the short term is so uncertain.

Continuous polls on the outcome of provincial referendums will unnerve foreign exchange and money markets as surely as day follows night. Increased volatility will result in either higher interest rates or a lower dollar, or both. Violently adverse capital movement will need to be offset by a strongly positive current account (via a sharply lower exchange rate) and/or a substantial interest rate premium *vis à vis* the US rates. Neither of these, however, is sufficient by itself to generate a positive swing in the current account balance of tens of billions of dollars. A substantially weaker rate of economic activity is needed to turn the trick.

The chickens have come home to roost. Unfriendly (to the private sector) governments (federal, provincial) run by mediocre politicians produce unimaginative, contradictory, and unworkable solutions. This in turn produces a real shock to the economy in much the same way as a war would or the famous quadrupling of the price of oil.

Notwithstanding the magnificent conduct of monetary policy on the part of the Bank of Canada, the world money markets have soured on Canada's politicians and are demanding immediate repayment. In the face of this real (as opposed to nominal) shock, we are throwing in our towel and belatedly label the recent decline a bear market.

STRATEGY: Long positions were stopped out at 8187, basis December '92. Initiate new short positions: Sell December 1992 Canadian dollar at market; place stops at 8335, close only.

Chart 3
CME CAN. DOLLARS



STOCK INDEX FUTURES

Yes, buy calls!

On August 11, we advised purchase of September 1992 S&P 500 call options via our Hotline Update. Subscribers thought that we had gone crazy. And suggested, of course, that we had meant puts. We thanked them for their concern but reiterated that we had indeed meant calls.

Our argument runs as follows: The economic recovery is weak but solidly based, a perception that increasingly sets us apart from many Wall Street economists who are anticipating a triple dip. Because our view is not so obvious, it clearly cannot be overdiscounted in the market place. What is more, the behavior of corporate insiders, strongly on the buy side, underpins our analytic-intuitive position: Better, although not much better, times are ahead.

If our forecast is correct, the market can fall only when and if it becomes exuberant, which leads to a technically weak overbought position. But this market is far from being exuberant. In fact, sentiment has been quite negative. Already, last month we cited the unusually long period (five weeks) in which a very low 25% bullish consensus prevailed. To this indicator we must now add the virtual death of the IPO market, the very large increase, to 9.5%, in mutual fund cash reserves (an indication of excessive caution on the part of these herd-like professionals), the extremely low volume of the lower-priced speculative stocks relative to the more defensive big capitalization stocks (AMEX volume to NY Stock Exchange volume has been running below 6% as in June 1982, June 1984, and November 1988), and the extremely low level of specialist short selling on the NY Stock Exchange.

This powerful combination of solid but unrecognized fundamentals and very negative sentiment should produce an explosive market rally.

STRATEGY: *You are long September 420 calls, which expire this coming Friday. We advise exercising this call, remaining long, and placing stops at 415, close only. Alternatively, on the day before expiration, roll over September call into a December 420 or 425 call.*

Chart 4
S & P CASH



COMMODITIES

Soybeans

No change. Remain long November 575 calls against the sale of 650 calls.

Cocoa

No change. Remain long the December 1100 calls.
- David B. Rothberg

FRIEDBERG CAPITAL MARKETS

Datapoint Corporation

Bonds: Datapoint Corporation 8 7/8%,
Maturity date: 1/6/06
Convertibility: 55.231 shares of common stock
Recent price: 67½
Yield to maturity: 14.86%.

Datapoint Corporation is a company principally engaged in the development, manufacture, acquisition, marketing, and servicing of computer and communication products, both hardware and software for integrated network systems with annual sales of \$260 million.

Until very recently the fortunes of this company were dependent on the favorable resolution of an infringement of a US patent relating to data-entry lawsuit. Northern Telecom, the plaintiff, informally suggested that the high range of possible damages might have exceeded \$100 million, which most likely would have bankrupted the company.

Fortunately, a settlement was announced a few weeks ago: Datapoint had agreed in principal to pay \$5 million in cash and as much as \$25 million and additional payments in the next 10 years, half of which was based on its profitability. The settlement is subject to approval by both company's boards and by Datapoint's senior lenders.

Also earlier this year Datapoint was able to reduce the accumulated but unpaid dividends on the old preferred stock via an exchange offer for new preferred stock that pays a dividend almost 1/5 the amount paid on the old preferred.

These two developments refocused our attention on the company's constructive coverage ratio (almost six times), its significant \$20 million cash hoard, and its 2.3 ratio of debt to market capitalization, a heavy but not totally intolerable burden.

These 14.9% convertibles offer an intriguing turnaround potential. We should point out that the company is 38% controlled by Mr. Asher B. Edelman, its chairman of the board, one of the original take-over artists of the '80s, and one of the few survivors of that era.

We currently offer Datapoint Corporation convertibles to risk-conscious accounts.

Recommended bond portfolio allocation for new portfolios

For new portfolios, we recommend the following investments:

Danish krone (& other EMS currencies, ECU)	20%
US dollar high-yield convertible bonds	20%
Argentina BICV	15%
U.S. dollar FRN	30%
Finnish Markka	15%

**Chart 5
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, ECU, CD, SAR, ITL, ARG, FIN) or revalue for JY, before the interest rate advantage/disadvantage is overcome by currency depreciation/appreciation. Rates as of September 10, 1992.

	US \$	NEW ZEALAND \$	AUSTRALIAN \$	DEUTSCHEMARK	SWISS FRANC	JAPANESE YEN	DANISH KRONE	BRITISH POUND	FRENCH FRANC	EUROPEAN CURRENCY UNIT	CANADIAN DOLLAR	SOUTH AFRICAN RAND**	ITALIAN LIRA	ARGENTINEAN PESO	FINNISH MARKKA	
1 year	3.16%	Tourist Hotel '93 yields 6.99% (.5276 NZ/US)					Denmark 8% '93, yields 10.46% (6.02 Dkr/US)					ESCOM 11% '93 yields 11.53% (.2418 US/SAR)				
2 year	3.83%		CBA '94, yields 7.18% (.6812 A\$/US)				Denmark 9% '94, yields 10.39% (6.351 Dkr/US)									
3 year	4.35%										Ont. Hydro '96 yields 7.35% (1.3274 US/CD)		N.I.B. '96 yields 14.25% (1457.45 ITL/US)			Finland '95 yields 13.61% (5.775 FIM/US)
4 year	4.80%			Bk. of N.S. '96 yields 8.63% (1.6746 US/DM)		World Bk. '96 yields 4.19% (121.44 US/JY)		Sweden '96 yields 9.79% (1.5955 BP/US)	Credit Lyonnais '96 yields 9.59% (5.907 FFr/US)		RBC 9% '97 yields 7.19% (1.3344 US/cd)					
5 year	5.28%			World Bank '97 yields 7.37% (1.6002 US/DM)												
6 year	5.33%				Australia '98, yields 7.29% (1.441 US/SF)											
8 year	5.99%			World Bank '00 yields 7.78% (1.5697 US/DM)						U.K. 9% '01 yields 9.32% (1.156 ECU/US)						
9 year	6.12%													BIC V '01 yields 19.74% (.3339 US/ARG)		
Spot Exchange Rate	-	.5472	.7258	1.4505	1.29	124.3	5.619	1.9215	4.94	1.4015	1.2192	.2615	1110.5	.99		4.475

*For example, since a US\$-based investor would receive 990 basis points (1425-435) by holding the NIB Italian lira bond, the ITL can depreciate to 1457.45 ITL/US from the present spot exchange rate of

1110.50 ITL/US over the next 3 years for the ITL 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.

FRIEDBERG'S

**Chart 7
FOREIGN CURRENCY BONDS**

Date: September 11, 1992

WE OFFER THE FOLLOWING BONDS SUBJECT TO CHANGE WITHOUT PRIOR NOTICE:

<u>ISSUER/MATURITY DATE/COUPON</u>	<u>BID</u>	<u>OFFER</u>	<u>CURR. ANN. YLD. TO MTY.</u>	<u>NEXT PAYMENT DATE</u>
DEUTSCHE MARK DENOMINATED				
BANK OF NOVA SCOTIA 5 5/8% 07/05/96 RRSP eligible	90.15	90.90	8.63%	May 07
WORLD BANK 5 7/8% 4/02/97 RRSP eligible	93.10	93.85	7.57%	Feb.04
WORLD BANK 9% 13/11/00 RRSP eligible	106.35	107.10	7.78%	Nov.13
FINNISH MARKKA DENOMINATED BONDS				
REP. OF FINLAND 11% 15/6/95	93.45	94.20	13.61%	Jun.15
ITALIAN LIRA DENOMINATED BONDS				
NORDIC INV. BANK 12 3/4% 19/04/96	94.05	94.80	14.25%	Apr.19
SWISS FRANC DENOMINATED BONDS				
GOVT. OF AUSTRALIA 5% 30/10/98	87	89	7.29%	Oct.30
DANISH KRONE DENOMINATED BONDS				
KINGDOM OF DENMARK 8% 20/08/93	97 1/8	97 7/8	10.46%	Aug.20
KINGDOM OF DENMARK 9% 15/11/94	96 5/8	97 3/8	10.39%	Nov.15
ECU DENOMINATED BONDS				
UNITED KINGDOM 9 1/8% 21/02/01	98.05	98.80	9.32%	Feb.21
BRITISH POUND DENOMINATED BONDS				
KGDM OF SWEDEN 8 3/4% 29/5/96	96.05	96.80	9.79%	May 29
FRENCH FRANC DENOMINATED BONDS				
CREDIT LYONNAISE 9 1/2% 23/12/96	98.85	99.60	9.59%	Dec.23
JAPANESE YEN DENOMINATED BONDS				
WORLD BANK 5 3/4% 7/8/96 RRSP eligible	104 3/4	105 1/2	4.19%	Aug.07
CANADIAN DOLLAR DENOMINATED BONDS				
ONTARIO HYDRO 10 7/8% 08/01/96 (semi annual)	111 3/4	112 1/8	7.35%	Jul.08
EKSPORTFINANS 7 3/4% 5/11/97	102 1/2	103	7.03%	Nov.05
ROYAL BANK OF CANADA 9 1/8% 7/1/97	106 1/8	106 7/8	7.19%	Jul.7
NEW ZEALAND DOLLAR DENOMINATED BONDS				
TOURIST HOTEL 0% 04/06/93	94 1/2	95 1/2	6.99%	4/6/93
SOUTH AFRICAN RAND DENOMINATED BONDS				
ESCOM 11% 31/10/93 (semi)	99	99 3/4	11.53%	Oct.30
AUSTRALIAN DOLLAR DENOMINATED BONDS				
COMMONWEALTH BANK OF AUSTRALIA 14% 01/07/94	110	111	7.18%	Jul.07
ARGENTINEAN PESO DENOMINATED BONDS				
ARGENTINA BIC V FIXED/FLOATING 1/05/2001 callable in full on any interest date	90.49	91.24	19.74%IRR	4th day of mth.
U.S. DOLLAR DENOMINATED FIXED CONV. BONDS				
DATAPPOINT CORP. 8 7/8% 1/6/06 CV @ \$18.11 p/sh (semi)	63 1/2	65 1/2	15.37%	Dec.01
COOPER CO'S 10 5/8% 01/03/05 (semi) CV @ \$27.45 p/sh callable in 1995	83 1/2	86 1/2	13.23%	Mar.01
DICEON ELECTRONICS 5 1/2% 1/3/12 (semi) CV @\$39.50 p/sh	35	38	16.50%	Mar.01
BURNUP & SIMS 12% 15/11/00 (semi) CV @\$16.79 p/sh	84 1/2	87	15.33%	Nov.15
ATARI CORP. 5 1/4% 29/4/02 CV @\$16.31 p/sh	48	50	15.96%	Oct.29
U.S. DOLLAR DENOMINATED FIXED RATE BONDS				
FARM CREDIT CORP. 7 3/4% 10/06/96 RRSP eligible	106 3/4	107 1/2	5.46%	Jun.10
REPUBLIC OF ARGENTINA 7/10/93 11% (semi) 1 yr. put	104	104 3/4	6.37%	Oct.07
U.S. DOLLAR DENOMINATED FLOATING RATE NOTES				
UNITED KINGDOM 24/09/96 3 mo. LIBID-1/8 (qtly)*callable @ 100	99.95	100.25	3 11/32%	Sep.30
REPUBLIC OF ITALY 30/04/93 3 mo Limean (qtly)	99.69	100.09	3 11/16%	Oct.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
Canada & U.S.A. 1-800-461-2700

THE EXOTICS

Finish markka

As discussed on a number occasions in the past, and most recently in our November 1991 issue, excessive wage costs and rigidities aggravated the Finnish recession, and have made it the deepest contraction in the OECD (see Chart 7). By our estimates and prior to the November devaluation, wages had become as much as 20% more expensive than in Germany, after currency adjustments.

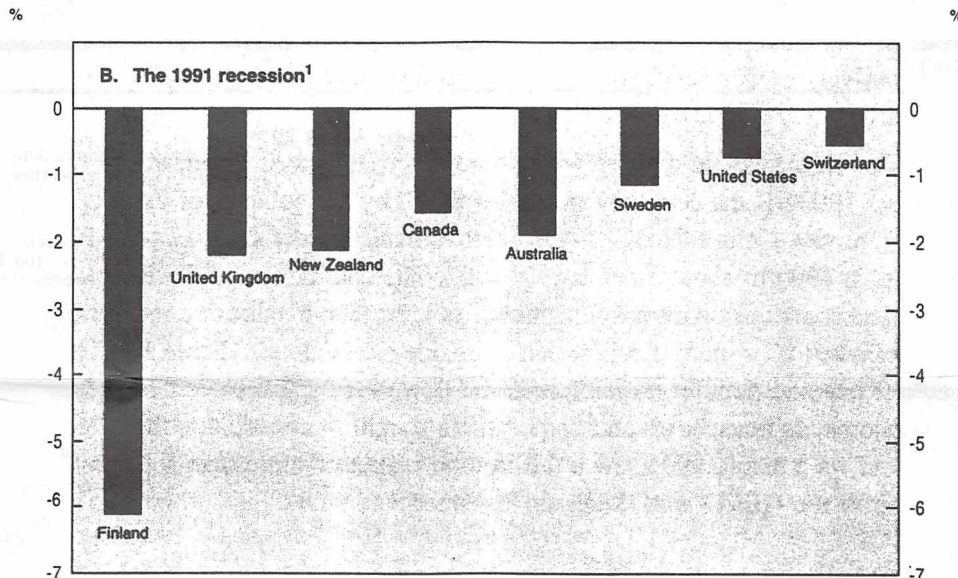
Short of decreeing by law this sharp reduction of nominal wages (politically impossible) Finland's only recourse was to devalue. And devalue they did by allowing the market to float downwards on Sept. 7. The immediate 15% depreciation coupled with the earlier November 1991 12.3% devaluation have more than restored Finland's competitiveness. And to boot gave us an excellent profit.

There is still uncertainty surrounding future prospects.

Among them the very weakened financial system, which has necessitated a lifeline (and which is likely to necessitate even a larger one in the near future) and the weak prices for its exports. Moreover, Finland will require a sizable improvement in the current account position to contain the increase in the net foreign debt, which now stands at over 35% of GDP. Despite these problems, the worst, at least in terms of currency levels, is over. If we are to believe official announcements, the markka is to float for a number of months and hopefully for much longer than that. In retrospect tying its currency to the rising deutschemark while in the midst of a severe recession was a disastrous error.

Finish asset markets, bonds and stocks, are starting to look attractive. In particular we are attracted by four-year to six-year government paper yielding in the vicinity of 13¾%.

Chart 7



1. GDP real growth in 1991.
Source: OECD, National Accounts.

FOREX RATES & UPDATE

<i>Currency</i>	<i>Spot</i>	<i>3-Month</i>	<i>12-Month</i>	<i>Comments vis à vis US\$</i>	<i>Comments vis à vis DM (Spot DM: 1.4980)</i>
*Australian dollar	.7255-.7266	.7206-.7214	.7035-.7055	Cover	Cover
*Belgian franc	29.68-29.72	30.15-30.22	31.45-31.59	Sell	Neutral
*Danish krone	5.5750-5.5850	5.6880-5.7050	5.9875-6.0125	Sell	Cover
*Dutch guilder	1.6240-1.6250	1.6507-1.6522	1.7225-1.7250	Sell	Neutral
*Finnish markka	4.4700-4.4800	4.6025-4.6275	4.9100-4.9500	Cover	Cover
Greek drachma	178.75-179.25	191.75-197.25	215.75-226.25	Neutral	Neutral
Hong Kong dollar	7.7291-7.7304	7.7281-7.7321	7.7441-7.7601	Neutral	Neutral
*Irish punt	1.8400-1.8430	1.8020-1.8090	1.7040-1.7170	Sell	Neutral
*Italian lira	1103-1105	1152-1162	1247-1275	Sell	Neutral
Malaysian ringgit	2.4954-2.4964	2.4734-2.4884	2.5354-2.6064	Neutral	Neutral
New Zealand dollar	.5465-.5475	.5423-.5438	.5315-.5340	Neutral	Neutral
*Norwegian krone	5.68-5.70	5.85-5.88	6.16-6.22	Sell	Neutral
*Portugese escudo	126.00-126.30	130.00-130.75	139.00-140.80	Sell	Remain long
Singapore dollar	1.5956-1.9566	1.9526-1.9561	1.9476-1.9586	Neutral	Neutral
*Spanish peseta	93.70-93.80	96.13-96.31	103.35-103.70	Sell	Liquidate
*Swedish krona	5.27-5.28	5.50-5.56	5.87-5.98	Sell	Neutral

Explanatory Notes

*Denotes change in recommendation from last newsletter

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

Tuesday, July 28:

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

Friday, July 31:

The market letter was mailed on Wednesday. There are no changes or new recommendations.

Tuesday, August 4:

There are no changes or new recommendations.

Friday, August 7:

There are no changes or new recommendations.

Tuesday, August 11:

There are three new recommendations:

- 1) Liquidate long Euro-D-mark puts and outright short positions. The rise in interest rates in Germany may be nearly over.
- 2) Purchase Dec. 106 T-bond call options at the market.
- 3) Purchase Sept. 420 S&P call options at the market.

Friday, August 14:

This is a review of recommendations for the week. On Tuesday Aug. 11, we liquidated long Sept. 9025 Euro D-mark puts at approximately 7 pts and outright short positions. On the same day we purchased Dec. 106 T-bond call options at approximately 154 and purchased Sept. 420 S&P call options at approximately 5.70.

Tuesday, August 18:

There are no changes or new recommendations.

Flash update, Monday, August 24, 8:35 am:

Liquidate Dec. 106 T-bond call options at the market.

Tuesday, August 25:

This is a repeat of the flash update on Monday, Aug. 24. We liquidated Dec. 106 T-bond call options at 115. There are no other changes or recommendations.

Friday, August 28:

This is a review of recommendations for the week. On Monday, Aug. 24, at 8:35 am via flash update, we liquidated Dec. 106 T-bond call options at approximately 115. There were no other changes or new recommendations.

Tuesday, September 1:

There are no changes or new recommendations.

Friday, September 4:

There are no changes or new recommendations.

Tuesday, September 8:

There are no changes or new recommendations.

Flash update, Friday, September 11, 8:25 am:

Sell Dec. D-mark at the market.

Friday, September 11:

This is a complete summary since our last market letter dated July 26, of all liquidations of open positions and new recommendations that remain outstanding.

On Tuesday Aug. 11, we liquidated long Sept. Euro-mark puts very profitably and outright short positions. We purchased Sept. 420 S&P call options at approximately 5.70.

On Friday Sept. 11, via flash update at 8.25 am we sold short Dec. D-marks at 6845. We now wish to add the following new recommendation to sell Swiss franc, Japanese yen, EMS and EMS-related currencies at the market.

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