

# FRIEDBERG'S

## COMMODITY & CURRENCY COMMENTS

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### Three cheers for New Zealand

Sustained economic growth under socialism has proven as elusive as the Holy Grail. Indeed, socialism has literally failed to deliver the goods. Recognizing that fact, many politicians from both the left and the right have raised the obvious question: How do we move from socialism to a liberal economic regime, particularly in light of the fact that there are no examples of successful transformations? To answer that question, we must look no further than Chile, Guangdong (South China), and New Zealand, because they, in fact, have engineered successful transformations.

In this piece, we focus on New Zealand since it offers yet another attractive trading opportunity. (Note that since 1985, we have profited handsomely by trading the New Zealand currency and bonds. And more recently by trading in stocks.) In 1960 New Zealand had a much-advertised high standard of living. However, the seeds of decline, socialism, had begun to sprout. Indeed, New Zealand had a Swedish-style welfare state. In consequence, while socialism bloomed, economic rot set in.

Per capita income, which had been the seventh highest in the world in 1960, fell to the rank of eighteenth by 1984. Over the same period, New Zealand's inflation rate averaged over 2% more than the average of the OECD countries, and unemployment, which had been close to zero, moved up to about 5%. In addition, external debt more than tripled as government expenditures soared to 41.5% of GDP and fiscal deficits became endemic.

In an attempt to stem the tide, Sir Robert Muldoon's center-right National government applied even more socialist medicine. From 1979, Sir Robert embarked on a series of "Think Big" public investment projects. The total expenditure on those amounted to about 18.4% of the 1984 GDP. From 1982, Sir Robert — in an attempt to control inflation, improve export competitiveness, and turn around the sad fortunes of New Zealand's balance on its external accounts — employed a vast array of interventionist policies. By 1984, New Zealand was saddled with a comprehensive freeze on prices, wages, dividends, rents, interest rates, credit growth of most financial institutions, and the exchange rate.

Sensing that they were on a sinking ship, New Zealanders threw the center-right National government out and installed Mr. David Lange's Labour government. That heralded a New Age for New Zealand. It was dubbed "Rogernomics" after Sir Roger Douglas, the Labour finance minister who masterminded the first bout of free-market reforms. Sir Roger cleared away the core of New Zealand's socialist underbrush. He finally went beyond the pale, however, when he proposed a flat-rate

income tax of 23% in the summer of 1988. Mr. Lange couldn't, in the end, countenance the death of New Zealand's progressive income tax, which Sir Roger had already cut in half, with a reduction in the top rate to 33% from 66%. (For an account of Sir Roger's methods and accomplishments, see the appendix to chapter 6 of *Capital Markets and Development* (1991) by Steve H. Hanke and Sir Alan A. Walters.)

New Zealanders finally turned Labour out in 1990 and replaced it with a National government. That gave new life to Rogernomics, because Ms. Ruth Richardson, an admirer of Sir Roger, was named finance minister. Hence, under the watchful eye of Ms. Richardson, "the mother of all budgets," New Zealand continues to push through free-market reforms. Even though many of Ms. Richardson's reforms have been hotly contested by Labour, it accepts virtually all the constraints driving current policy. For example, Dr. Michael Cullen, Labour's finance spokesman, has stated that "raising the tax burden simply isn't an option." In addition, the Reserve Bank Act, which was passed in December 1989, is carved in stone. That act made the Reserve Bank the world's most independent central bank and mandates one objective: price stabilization. At present, the inflation target is 0% to 2% by the end of 1993.

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

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

Incidentally, for those who might doubt just how hard-core Ms. Richardson is, it is worth mentioning that she was one of the first to lift the veil from President Clinton's economic program. On Feb. 18, Ms. Richardson said that President Clinton is "going to blunder in and we're going to have a high-taxing president on our hands as well as a protectionist on our hands. It's a pretty lethal combination." She went on to say that it is "sheer folly" to raise taxes to tackle a deficit. Her remarks brought forth a flurry of diplomatic traffic ("intellectual terrorism") from Washington. In consequence, on Feb. 21, Prime Minister Jim Bolger had a little chat with Ms. Richardson. Alas, Ms. Richardson will henceforth limit her remarks to issues specific to New Zealand.

\* \* \* \* \*

So much for the New Zealand story. The question remains: Have that country's free-market reforms begun to bear fruit? We think they have, indeed, brought New Zealand back from the dead. Chart 1 contains the basic economic indicators. Noteworthy is the fact that in 1992, New Zealand had the most rapid GDP growth of the OECD countries, and that its 1.3% inflation rate was second best. New Zealand has entered a zone of sustained growth and stable prices.

The growth is (and will continue to be) export-led. This is a result of New Zealand's improved external competitiveness, which can be measured in two ways — on a bilateral basis via purchasing power parity (PPP), or on a multi-lateral basis via real effective exchange rates. Although nominal exchange rate *vis à vis* the US dollar has fallen by almost 25% since the second quarter of 1988, the Kiwi is now fairly valued on a PPP basis, implying that it was about 25% overvalued on a PPP basis in 1988. This will assist New Zealand's agricultural, fisheries, and wood products exports, which account for about 60% of the total. It will also help its small, but growing, manufacturing sector regain market share abroad.

On a multi-lateral basis, too, the past few years of monetary restraint and cost control are starting to pay dividends. The real effective exchange rate of the kiwi, measured against a basket of eight other currencies of its major trading partners between the 1984 devaluation and mid-1988, appreciated by about 23%. But since monetary growth has been kept in check and inflation has been reduced to the second-lowest in the OECD countries, this must be regarded as a real depreciation or gain in competitiveness. Note that this contrasts to a nominal depreciation followed by inflation, which erodes competitiveness achieved by devaluation. In other words, the gain in New Zealand's competitiveness in the last

four years appears to be sustainable and compatible with continued low inflation.

That brings us back to the Reserve Bank Act of 1989, which made the Reserve Bank fully independent. To be credible, after years of a dismal inflation record, the Bank needs a transparent target and rules. The Reserve Bank now has the target and rules. Indeed, it is the first central bank in the industrial world to set a specific inflation target: 0% to 2% by 1993. To bolster credibility further, deviations from that target have made it costly for the Bank's first-class governor, Dr. Don Brash: If he fails to meet the target, he loses his job.

Given the new Reserve Bank Act, which is in fact a monetary constitution, we are confident that inflation will be within target by the end of 1993. Moreover, in private correspondence with Dr. Brash, we are also confident that the kiwi has little downside risk. The reason for this was laid out in analytic detail by Dr. Brash. The Bank's econometric work shows that for each 10% decline in the kiwi's trade-weighted index, there is about a 4% increase in New Zealand's consumer price index after a 12-month to 18-month lag. Given that the kiwi has declined by about 3.5% *vis à vis* the US dollar since July 1992, consumer prices in New Zealand should increase at about a 1.5% annual rate, holding all else constant, by the end of 1993. This doesn't leave Dr. Brash with much leeway to let the kiwi fall from current levels.

**STRATEGY:** *The five-year government bonds are yielding about 7.55%. With current inflation at 1.3%, a high real yield of 6.25% is currently being generated. That high real yield is partially explainable by the time lag necessary for investors to adjust to and accept the historically low inflation rate, particularly now that the economy is in an export-led recovery.*

*In addition, we must mention the liquidity premium in the relatively small and hence illiquid New Zealand bond market. However, given the new monetary constitution, we believe there is considerably more room than investors have allowed for further falls in nominal bond yields. After all, consider that five-year indexed, sterling gilts yield 3.5% (real). If we subtract that real yield from the current nominal 7.55% yield in New Zealand, the inflation rate implied is 4.05%, which is well above the current New Zealand inflation rate (1.3%) and also well above the upper range of the Reserve Bank's mandated target (2%). Hence, nominal yields are out of line and will fall.*

*Purchase 5-year New Zealand Government bond futures at market.*

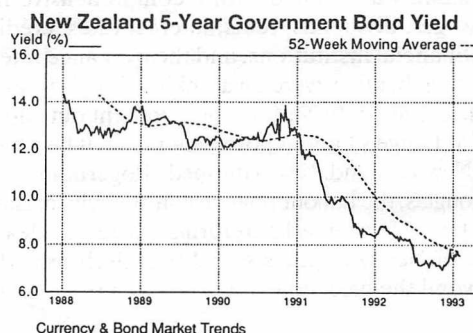
— Dr. Steve H. Hanke

Chart 1 – New Zealand Key Economic Forecasts

	1991	1992 (Est.)	1993 (Proj.)
Real GDP (% Chg.)	-2.0%	2.5%	3.0%
Unemployment Rate	10.3%	10.3%	9.7%
Consumer Prices (% Chg.)	2.6%	1.3%	1.0%
Budget Balance as % of GNP	-3.2%	-3.4%	-3.5%
Trade Balance (NZ\$ bn)	3.5	2.0	2.5
Current Acc'l Balance (NZ\$ bn)	-0.1	-1.0	-0.5

Source: Merrill Lynch

Chart 2



**JAPAN: THE NIKKEI**

# Facing reality

Trapped in a debt-deflation, Japan is quickly heading towards the deepest economic contraction since the Depression. Over the three months ended in December industrial production has fallen at a 10.2% annual rate, standing 8.2% lower than last December.

For the first time in the post-war period, retail sales were down 5.5% in November from a year ago and have fallen, in volume terms, at an incredible 10.9% annual rate in the three months to November.

It is precisely this weakness in domestic demand that is largely to blame for Japan's mounting current account surplus: In January, exports rose in value by 0.8%, and imports were down 6.4%. In the four years to 1991, as domestic demand grew by an average of 5.4% a year, Japan's imports boomed, and its trade surplus shrank.

A brief detour. Debt inflations are the result of excessive debt burdens. Excessive to what? Excessive to income. They are *triggered* by any number of "external" factors, i.e., stock market decline, monetary tightening, failure of a large financial institution, etc.

Once set in motion, a debt deflation will accomplish the task of destroying the excessive debt burden but at a considerable cost in output and employment. And the reason is that debt repayment and/or repudiation involves a cutback in spending (a rise in the savings rate), which in turn makes the new, lower level of debt still excessive in relation to the new, lower income.

The first layer of debtors to go are the most vulnerable ones. As the debt deflation proceeds, the slightly sounder debtors are "bankrupted," and so on. Depending on the economy's level of leverage, a \$1 debt deflation can translate into an 80¢ drop in income, or a 60¢ drop, or a 20¢ drop. If the process is unchecked, most vulnerable debtors will have either repaid the loans or repudiated them via bankruptcy. The remaining debts are perceived to be solvent, the debt deflation ends, and income activity stabilizes.

Once in motion, can debt deflation process be stopped? Leaving aside the question of its desirability, the answer is, yes. Deficit spending financed via government debt can offset the contractionary effect of debt deflation. This is precisely what happened in US during 1990-91 (see Chart 4). The deflation in

the private sector's debt was reducing nominal spending, threatening to snowball into outright deflation/depression. Increased government borrowing and spending halted the process.

In highly leveraged Japan, the process of debt deflation has been put into motion, triggered by the Bank of Japan's tight monetary policy.

Not only has the public sector, to date, not engaged in deficit spending, it enjoys a relatively large surplus! Japanese officials remain complacent about a prompt turnaround, and so they are unlikely to move very quickly to offset the private sector's deflation.

The West has been talking up the yen for years, compounding the problem: Domestic reflation, not yen appreciation, is the "solution" to the growing current account surplus (see next article).

As the depression deepens, stock prices must inevitably reflect the new economic reality. Only heavy government purchases of stocks has supported prices around the 17,000 mark on the Nikkei Index. In January, banks, including trust banks, which manage public funds, posted net stock purchases for the eighth consecutive month, buying a net ¥366 billion in equities. Presumably, public funds will continue to support prices until March 31 (if they do not run out of funds earlier), the end of the fiscal year, as an accommodation to financial institutions, which may fall afoul capital markets should stock prices sink below present levels. And then?

Only when government officials finally face reality, in terms of the magnitude of the "crash" and the likely prospects of economic activity, can it be said that the *bottom* has been reached.

At least, at the Bank of Japan, reality has begun to set in: It is urging Japanese banks to write off non-performing loans, possibly worth several thousand billion yen, in a radical shift of policy.

We believe that stock prices are headed substantially lower in coming months. We also believe that short-term interest rates will have to be lowered to 1% or less to bail out the collapsing banking system.

**STRATEGY:** *Stay short the Nikkei Index via futures and/or via puts. Remain long SIMEX European call options.*

Chart 4

## U.S. CREDIT MARKET DEBT IN BILLIONS OF 1985 US\$

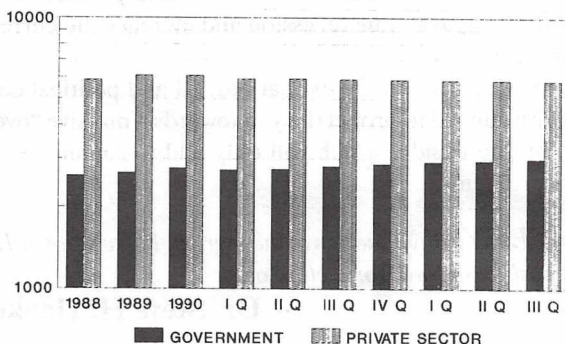
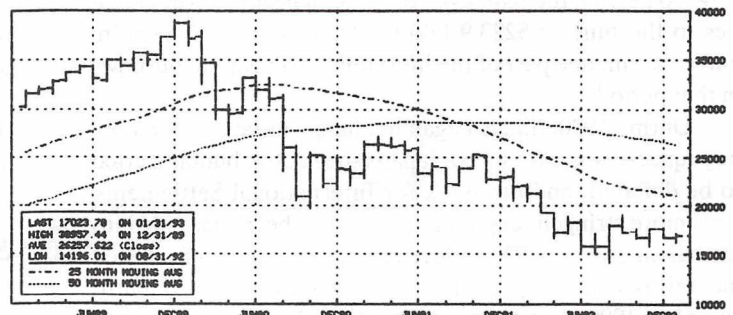


Chart 5

## NIKKEI 225 INDEX



Courtesy Bloomberg

**JAPAN: THE YEN**

# The curious case of Japan's balance of payments

The Secretary of Treasury and the financial press are at it again. As the dollar falls to all-time lows against the Japanese yen, we are told that the yen is soaring because Treasury Secretary Lloyd Bentsen wants it to soar. This is little more than puffery. Since last April, well before Mr. Bentsen had acquainted himself with the politics of currency markets, the yen has been strengthening and has entered a zone of fundamental strength.

To appreciate this, we must look no further than the yen's economic fundamentals, particularly Japan's balance of payments and the forces that drive capital flows. The most striking feature of Japan's balance of payments accounts from 1981 through 1992 has been its large current account surpluses. Indeed, the surpluses averaged almost \$55 billion per year. At present, those surpluses continue to surge, and are running at about \$120 billion on an annualized basis. As Japan slides further into recession, 1993 promises to bring more of the same, with the current account surplus forecast to be at least \$130 billion.

During the 1981-90 period, the Japanese were part of a massive recycling operation: On the one hand, Japan was running large current account surpluses, while on the other hand, these were more than offset by long-term capital outflows each year. Cumulative current account surpluses in that period totalled \$462 billion, and long term capital outflows totalled \$685.1 billion.

Noteworthy is the 1984-90 period, when long-term capital outflows greatly exceeded current account surpluses, with the cumulative current account surpluses totalling \$429.6 billion and the long-term capital outflows totalling \$645.9 billion. During that period, Japanese banks and other financial institutions were investing in long-term foreign assets, and they were financing part of their purchases by adding to their short-term foreign borrowings. During the 1984-90 period, the banks were taking advantage of their strong capital positions to ride the yield curve abroad; they borrowed short-term and lent long-term in a big way. Indeed, during the 1984-90 period, the banks piled up foreign short-term liabilities to the tune of \$223.9 billion. These liabilities were incurred to finance part of the huge long-term capital outflows in that period.

During 1990, things began to change in Japan: A monetary squeeze was introduced; Japan's speculative bubble started to be deflated; and the Bank for International Settlements' new, more stringent capital requirements began feeding into the banking system. These developments dramatically altered incentives and the pattern of capital flows. Consequently, since late 1990, long-term capital inflows have been recorded

as Japanese investors liquidated overseas holdings in order to meet their liquidity needs at home. These long-term capital inflows have been more than offset by short-term capital outflows, which have resulted because Japanese banks have been paying off their short-term foreign liabilities in order to strengthen balance sheets. The recycling of current account surpluses (plus long-term capital inflows) has continued only because of the Japanese banks' massive paydowns on their short-term liabilities.

Alas, the paydown process has begun to run its course because the banks have paid off the bulk of their short-term liabilities. Consequently, the recycling of current account surpluses (plus long-term capital inflows) has begun to grind to a halt. With Japan's current account surplus exceeding its net private sector capital outflow, there is only one way for the yen to move; it must increase in value. To accommodate this pattern of flows and allow the balance of payments to balance, the Bank of Japan will have to add to its substantial foreign exchange reserves.

**IMPLICATIONS:** As Japan's recession deepens, its current account surplus will surge, largely because of falling imports. That surplus will exceed total private sector capital outflows. Hence, the Bank of Japan will add to its foreign exchange reserves, and the yen will appreciate. Japanese exporters will, of course, see their profits squeezed further as a result.

This process will continue in a natural manner. Moreover, it will be further stimulated by the politics of currency markets. The international politicians are focusing only on Japan's current account surpluses, which are viewed as a problem. Not realizing that the surging surpluses are caused, in large part, by Japan's recession, the politicians will beat the drums for a higher yen.

That higher yen — they wrongly think — will dramatically reduce the surpluses by cutting exports. In the short run, which is where the politicians live, the higher yen might actually do little more than squeeze exporters' profits, which will further aggravate the recession and increase the current account surpluses.

Consequently, it appears that natural and political conditions are aligned to propel the yen towards a massive "overshoot" on the upside, which will only add to Japan's recessionary problems.

**STRATEGY:** Buy June yen at the market. Place stops at 121 yen/\$, basis cash New York, close only.

— Dr. Steve H. Hanke

**DEUTSCHEMARK**

## Aborted rallies

Deutschemark rallies have been repeatedly aborted by continuous expectations of Bundesbank easing.

Despite renewed signs of economic weakness, chief among them the drop in December's industrial production and manufacturing indexes as well as the 68,000 increase in the number of unemployed, domestic spending exceeds savings, producing a continuous current account deficit (see Chart 8).

No doubt, this excess spending is being caused by an enormous public sector deficit, equal to an estimated 7.5% of GDP. Monetary policy, already expansive (M1 grew 10.3% year on year, M3 grew 8.1% for the same period), cannot prudentially be made easier. At the same time, while consumer prices in Bavaria are down to 4.2% compared with 4.4% in January, the cost of rents and services are still rising at

6.2% and 7.6%, revealing a disturbing entrenchment in non-tradeable inflation.

We continue to believe that the Bundesbank does not enjoy the "room" to ease that is anticipated by the market. Nor do we believe that the German recession will turn out to be as severe as is being forecast, chiefly because the household, corporate, and banking sectors are not showing the levels of excessive indebtedness typical of the UK, Japan, or even the US.

**STRATEGY:** We are long March '93 DM at around .5996 as per Hotline Update of Feb. 5. Retain stops at .5955, close only.

We are also long June '93 Euro-DM puts, 92.50 and 92.75 striking. Maintain positions.

Chart 8

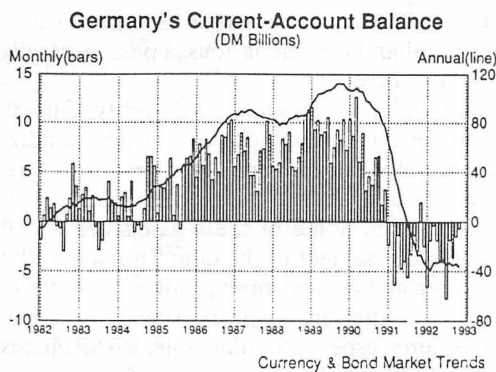


Chart 9

CME DEUTSCHE MARK MAR'93

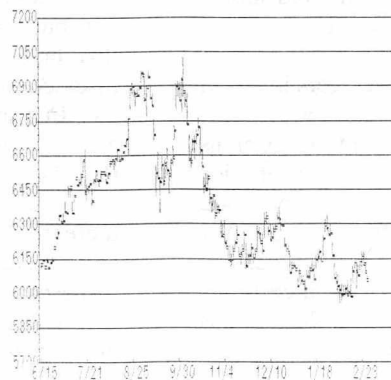
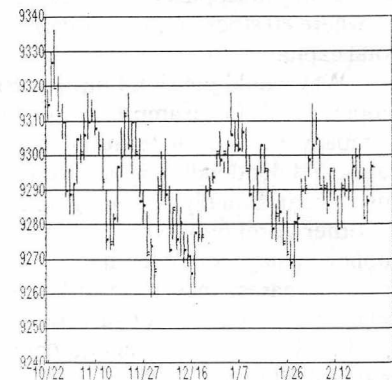


Chart 10

LIF EUROMARK JUN '93

**CANADA**

## The folly of investment controls

*If you could buy anything you wanted elsewhere — I mean, if you didn't have to own one Canadian stock — how many would you actually buy?*

— Sherry Cooper, Chief Economist, Burns Fry

In *Human Action*, his classic treatise on economics, Ludwig von Mises neatly describes the consequences of currency controls. Governments, he observes, impose controls to prevent capital flight, a pejorative term for the rational, efficiency-seeking movement of money from poor investments in one country to wiser investments in others. In a hypothetical example, he supposes that a government of France imposes currency controls during a period of high inflation. The result is merely that the French are forbidden to sell off dubious investments to foreigners: "The manifest outcome is to make some Frenchmen poorer without making any Frenchmen richer."

Canada offers a current example. For nationalistic reasons, the Canadian government imposes stringent investment controls on the bulk of Canadians' savings. Canada's pension funds manage \$300 billion of these savings; Canada's Registered Retirement Savings Plan (RRSP) funds comprise another \$150 billion. Federal law requires that 82% of pension and retirement savings be invested in Canada. In 1993, another \$25 billion will flow into these funds; the domestic investment quota will hold captive \$20 billion.

These controls don't limit merely the amount of pension-RRSP savings that can be moved to other countries. RRSP regulations, for example, prohibit the buying of foreign issue government bonds of any kind, even with the authorized foreign-content quota. The RRSP investor who wishes to hold government debt securities *must* buy the bonds of Canadian governments (with the exception of such esteemed

pseudo-governmental agencies as the World Bank).

Von Mises would appreciate the consequence of these controls, which is the increasingly perfunctory pursuit of too few investment opportunities by too much ready cash. ("An object that is not in short supply is not an economic good," von Mises says. "As money must be an economic good, the notion that it will not be scarce is absurd.") Yet Canadian money managers must invest their spiralling stocks of cash in *something*. And in general terms, *something* is either 1) the relatively small number of big-cap companies on Canadian stock exchanges or 2) Canadian government bonds.

Fortunately, from this perspective, money managers have no shortage of Canadian government bonds to buy. Canadian provincial governments have run up almost \$50 billion in deficits in the past two years, a 50% increase in their net debt. The federal government continues to crank out debt at the rate of \$35 billion a year. Canada's governments are now \$650 billion in the hole; the country's public debt-to-GNP ratio approaches 100%; its external interest-service cost ratio exceeds Venezuela's and approaches Brazil's.

Equity investment options within Canada, however, don't exist in such abundant supply. Money managers who want a balanced pension fund or retirement fund portfolio must go with the bulk of their RRSP funds to Canadian exchanges where they must pick and choose from a very limited supply — where 80 stocks represent perhaps 80% of the exchanges' total capitalization.

Why would pension fund and RRSP managers invest in Imperial Oil, for example, rather than in Imperial's parent company Exxon? In terms of book value, price/earnings ratio, and dividends, Exxon historically has been a superior investment. Equally discouraging comparisons can be made of other foreign-parent/Canadian-subsidiary stocks. Yet money managers buy the inferior Canadian equity because, in many cases, they have little choice. It's an incestuous relationship, and it's not surprising that the last decade has produced evidence of genetic deprivation in the Canadian markets' returns.

SEI is one of the international money-management consulting firms that advises the pension-fund industry. From its Toronto office, SEI calculates that the TSE index has yielded an annual return of 9.1% during the past 10 years. By comparison, the S&P 500 has yielded 16.5% and the Morgan Stanley EAFE (Europe, Australia, and Far East) has yielded 17%. The international portfolio, in other words, produced a 65% to 70% higher return. In a five-year comparison, the TSE index returned 4.8%; the S&P 500 returned 15.4%. (The market crash in Japan dragged down the five-year EAFE return to 0.9%). A hypothetical "all-Canada" portfolio produced returns comparable to the TSE index.

These results aren't exactly a revelation. For the past decade, Canada has not been a particularly good place to invest all (or indeed 82%) of your money. There are probably many reasons why. Two of the most important, however, are frequently forgotten, perhaps because they are self-evident: 1) Canada's mandatory domestic-investment rules tend to prop up inflated equity prices; 2) Canada is too small a country to produce authentic diversity in the investments it offers to the big pension and RRSP trustees.

Given Canada's nationalistic sensitivity, it isn't considered patriotic in this country to assess the country's investment

performance on these grounds; few complaints are publicly expressed. Yet all money managers recognize the limitations inherent in the Canadian markets. Why limit investment choices to a few dozen companies, after all, when the international markets offer 10,000? It's equivalent to limiting your picks to stock symbols that begin with the letter Q.

There are insistent micro and macro consequences to all of this. For a Canadian whose savings are subject to federal investment restriction, there's a certain loss of returns. (A one percentage point differential in return on a \$1 billion pension fund, compounded for 10 years, means \$100 million in lost earnings; a seven point differential on \$370 billion means \$260 billion in lost earnings.)

For the Canadian market as a whole, there's a certain loss (past, present, and/or future) of efficiency-seeking foreign investment in Canada. We may be willing to force more and more billions of dollars into a limited number of stocks; foreign investors aren't — or at some point, won't.

Are we there yet? Perhaps not; but 1992 ended with growing evidence of foreign scepticism toward the Canadian market. In four of the last five months for which we have statistics, nonresidents were net sellers of Canadian stocks; in three of the last four months, nonresidents were sellers of Canadian bonds; and foreign purchases of Canadian debt securities fell 20% last year from 1991. The exits aren't packed yet; but many of the January forecasts for 1993 from Canadian banks and Canadian investment houses pessimistically assessed the shuffling of feet.

In a search for higher returns and for diversity, Canadians are pouring money into mutual funds with such abandon that the contrary investor must begin to feel nervous. Canadian mutual fund assets rose to \$67 billion in 1992, a 35% increase from \$50 billion. Some of these assets are RRSP assets, and are therefore subject to the domestic quota; the rest escapes the quota and may be more prudently invested.

The mutual funds that are disproportionately "Canadian" must be considered especially vulnerable. RRSP clients are getting more sophisticated; they now swap fund managers almost as casually as rock stars trade groupies. Many such clients, however, are immensely credulous, and think that Canada's past poor performance decade obliges 1993 to produce a boom. The current RRSP investment season, now at its end, appears especially burdened by excessive expectations.

Any significant drop on the Canadian exchanges this year (and perhaps even an insignificant drop) will send many mutual fund investors off on a promiscuous hunt for more astute money managers. And mutual fund exits, although clearly marked, are narrow. In what may or may not have been a glimpse of the future, two Canadian funds were compelled to freeze redemptions in December as investors abruptly took off in a hunt for higher returns.

The federal government thinks that its foreign investment controls are helping Canada build a domestic pool of capital that will make the country more competitive. It is, instead, making the country less competitive; and it is risking a domestic market disaster. Would the removal of these controls send more Canadian money abroad? Certainly. And if "too much" money left, smart foreign money would rush in and buy up the bargains that Canadian investors had foolishly left behind. The market mechanism, once again, would speedily produce an equilibrium.

In rhetoric and in treaty, the Conservative government has embraced North American and global free trade; in its investment controls, however, it confesses that Canadians (and, more specifically, Canadian governments) aren't ready to compete on the open market for investment money. Canadian are generally content with the investment restrictions; they think they are helping their country; further, they are thankful for the privilege of deferring taxes on their pension and retirement savings.

These investment controls, however, don't help the country. They merely form an investment dam, behind which has accumulated an enormous supply of restless money. In response, money managers have devised some investment strat-

egy spillways that let Canadian-quota funds grab hold of a foreign stock index at a distance; more such channels will be sought. In the end, the government must either build the dam higher (and impose more stringent controls) or the dam will surely crack. In either case, Canadian investors will take a bath.

– Neil Reynolds

**CANADIAN DOLLAR STRATEGY:** *We have been stopped twice of our short position. Move to the side lines. As the political campaign begins, volatility will increase, and perhaps a better opportunity will arise.*

Chart 11

CANADIAN DOLLAR SPOT



Courtesy Bloomberg

**STOCK INDEX FUTURES**

**Putting out the shorts**

The first significant break in stock prices was contained just above the early January lows. Undoubtedly, it was helped by falling bond yields, which saw the 30-year Treasuries trade to yield a record low 6.82%. The interest rates impact was most noticeable in the utilities sector, which gained on the week a remarkably strong 2.37%. It is rare indeed for the Industrials to begin a genuine bear phase while the Utilities sector rises to new highs.

Exceedingly high valuation levels remain a major source of concern, but, at least for now, the market has learned to live with this problem. Excess liquidity accompanied by negative short-term interest rates can find ways and means to rationalize outlandish price/book, price/earnings, price/dividend, and market capitalization/sales ratios.

Cash flow, it is said, significantly exceeds reported profits (see Chart 12) due to significant non-cash charges, leading a well-known investment firm to note that "reported earnings seriously understate the level and build-up of corporate cash flow and disturb investor perceptions of the current valua-

tion level of the market." This may be true, but it does not address the issue of the reason for these enormous non-cash charges: bad past management decisions.

Can the "quality" of earnings be so good when management has been and still is so bad? Moreover, it appears that even after-tax cash flow is not substantially higher than in early 1985, and yet stock indexes are 250% higher.

The difference, of course, is the level of interest, particularly short-term rates. A significant upward move in short-term rates will be the catalyst for the next bear market. Until then, the best we can expect is a 5% to 10% correction.

**STRATEGY:** *On Feb. 12 we liquidated our long futures and long call positions at substantial profits (see Hotline Update) and initiated, via the purchase of puts, a new short position. A close above 444.00, basis the cash S&P 500 Index, will indicate to us that the correction is over and new highs are in the offing. Should this be the case, liquidate recently acquired puts at the market.*

Chart 12

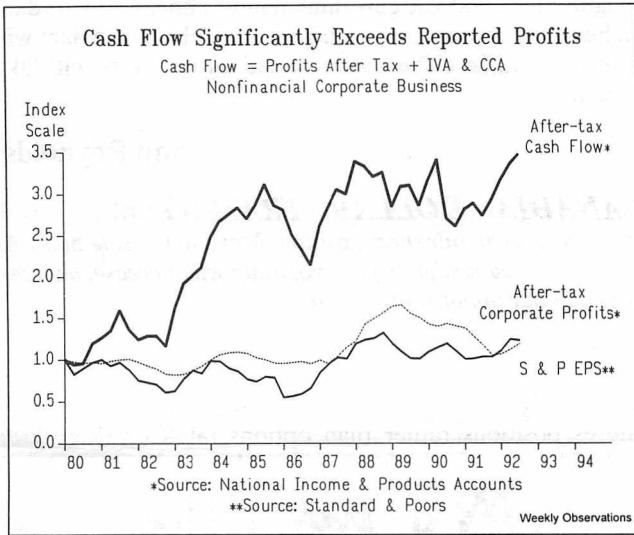
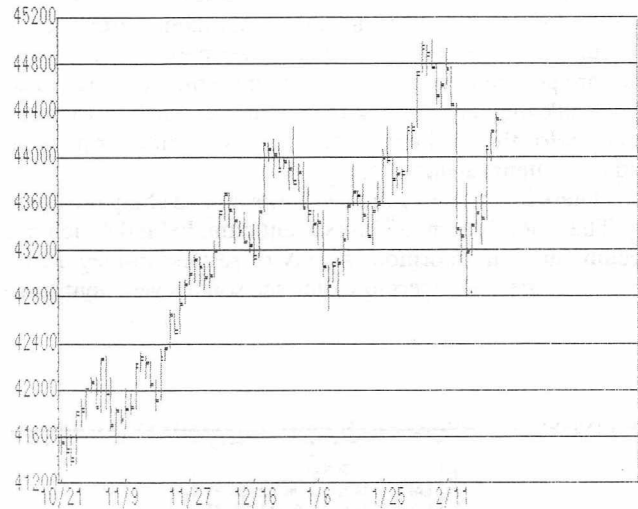


Chart 13 – CME S&P 500 INDEX CASH



**CRUDE OIL**

**Delicately poised**

While OPEC managed to “finesse” an agreement, the markets remain relatively unimpressed. And for good reason. Factoring in expected “cheating,” OPEC will still produce close to its productive capacity. The absence of Iraqi oil, shut in by order of the Allied forces, and the withdrawal of Ecuador (worth a few hundred thousand barrels per day) have allowed OPEC to talk about an agreement without resorting to “sacrifices.” In effect, present producing members are operating at almost full capacity.

Certainly, the incentive is there: Total real revenues have been collapsing over the past 18 years.

At the same time, Russian oil production continues to decline. According to Lev Tchovrilov, president of Russian’s biggest oil and gas producer, Rosneftgaz, Russian oil production will fall to 350 million tonnes in 1993 from 1992’s 395 million, 461 million in 1991 and 518 million in 1990, largely due to deteriorating infrastructure and higher domestic consumption than in the West due to inefficient refining techniques.

While exports have held up relatively better than production (a result of lower domestic consumption), they are still expected to fall to around 45-50 million tonnes in 1993 from 66.2 million tonnes in 1992. Can OPEC get luckier than that?

The future, however, is not so rosy. At slight improvement in Russian oil production can translate into a very substantial increase in exports, easily in the order of 1 million to 1.5 million barrels per day (mb/d). Also, sooner or later, Iraq will strike a deal with the Allies, allowing for the resumption of their very substantial 3.5 mb/d to 4.0 mb/d exports.

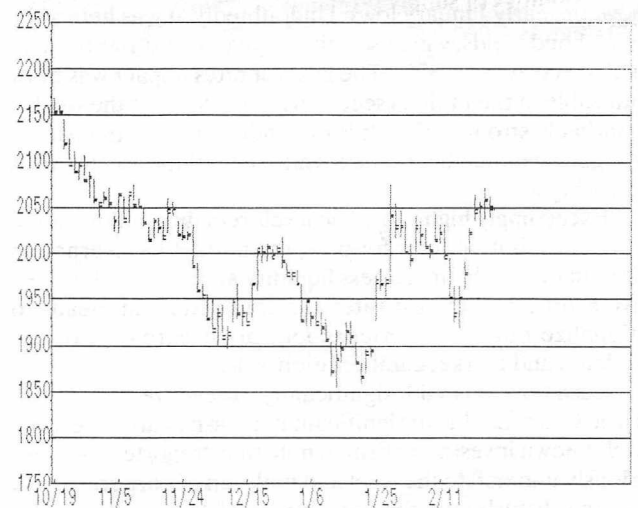
Seeing the handwriting on the wall, OPEC’s major producers — those with the largest in-ground reserves — are not

likely to easily accept output cutbacks.

Thanks to special circumstances, the market is delicately poised between stagnant world demand and OPEC ex-Iraq, ex-Ecuador production. It is difficult to know when the calm will be shattered, but it will be. And when it is, oil prices will fall towards their marginal cost of production.

**STRATEGY:** Retain put options, as they remain relatively cheap.

Chart 14  
 NYME CRUDE LIGHT APR '93



**COMMODITIES**

**Cocoa**

I recently came back from a wonderful vacation in the Mexican state of Oaxaca. In the cardboard box that acts as the receptacle for the majority of my mail was the mess of stuff that insidiously accumulates whenever one is away having fun. Among that stuff I found a bunch of scrunched-up hard copy that one of my thoughtful colleagues had ripped off the Reuters machine and left for my attention. Following are some excerpts:

*London, Jan. 19* — Gill and Duffus (the respected industry statistician) has raised its estimate for the world cocoa deficit in 1992-93 (Oct./Sept.) to 110,000 tonnes from a previous projection of 53,000 tonnes....It is clear the cocoa market is entering its second year of deficit....Given the uncertainty over both production and consumption, it is surprising prices are currently trading in the bottom half of the long-term trading range which has prevailed since 1989....The company believes the long period of "structural surplus" is over....There are signs consumption in the world's major markets is beginning to expand....The outlook for the former Soviet Union has improved significantly over the last four months....Given these circumstances, continued consumption growth will move the market into a period of "structural deficit."

*London, Jan. 28* — The structural surplus in the world cocoa market from 1984-85 to 1990-91 is at an end....said the International Cocoa organization (ICCO)....The resulting drawdown in stocks due to the predominance of deficits is expected to result in a recovery in prices in real and nominal terms....By 1996 *real* prices are projected 85% higher.

*London, Feb. 8* — The ICCO forecast a world deficit of 102,000 tonnes in 1992-93....Production was seen rising to 2.33 million tonnes (up 3% over 1990-91) while grindings (consumption) were put at a record 2.41 million (up 4% over last year)....The increase in grindings was partly due to a recovery in Eastern Europe.

I do not think it is too much sun that causes me to consider this commentary offered by the cocoa industry's most respected voices to be decidedly bullish. It does not take into account the possibilities of supply problems in general resulting both from sloppy husbandry during the previous four surplus years

and a resumption of El Niño. Nor does it take into account supply problems in particular — for example, Ivory Coast — the world's largest producer (737,000 tonnes harvested last year) — which is working to reduce its state subsidies to growers; and the possibility that some clever merchant may awaken China to the delights of Zero bars (my personal favorites). Thus, I am doggedly recommending retaining long investment-type positions.

Last month's \$80 per tonne shakeout in New York vindicates our long-term strategy of *investing* in cocoa by holding futures positions rather than options (at least short-term options), and of maintaining stops at *beneath* the low end of the long-term range rather than looking to "play" the position as a trade.

**Sugar**

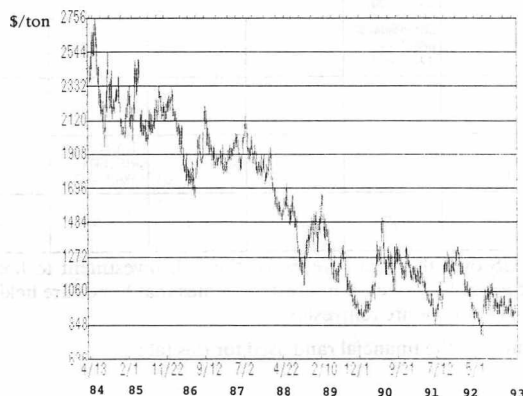
Sentiment regarding sugar fundamentals has taken a decidedly bullish turn since last writing. Projections for the current crop year's supply/demand balance call for a deficit of some 550,000 tonnes versus a surplus of 1.5 mln tonnes earlier in the season and 3.4 mln tonnes for last year's crop.

The revisions come from expected declines in China, India, Eastern and Western Europe. Cuba remains a wild card because, as was the case last year, little reliable first-hand information is forthcoming. (What is known about Cuba is that television sets, vacations, and even clothing are being offered by the beleaguered state to workers who will harvest the crop by hand. Fuel and machinery are in precious short supply).

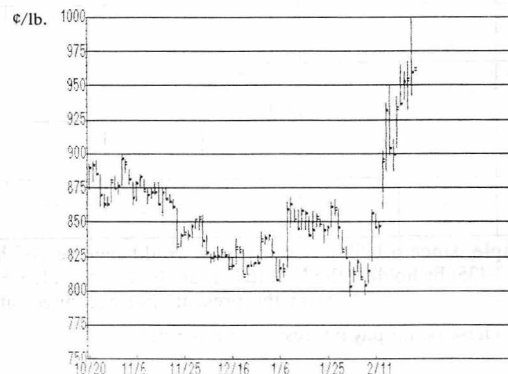
Cuba and uncertain weather — again resulting from a resumption of El Niño — lend more potential fuel to the bullish case. Still, since the bullish argument is more focused on supply rather than demand — unlike Cocoa — which has become extremely price elastic, we would look to take profits on a run-up to the 11¢ mark if the market should find its way there. Otherwise, maintain stops at the lows of 7.90 basis nearest contract.

— David Rothberg

**Chart 15 – N.Y. COCOA**



**Chart 16 – N.Y. #1 SUGAR MAR '93**



**FRIEDBERG CAPITAL MARKETS**

# Diceon update

Out of our currently recommended list, the one convertible that requires the closest monitoring is the Diceon Electronics bond. Diceon continues to experience very poor operating performance. The company attributes these rocky times to increased competition and general economic conditions. However, net sales increased to \$28.8 million compared with \$25.9 million last year. The other bright spot is that shipments compared with last year's first quarter were up 11%.

The company's Vice Chairman, Mr. Peter Jonas, repeatedly stated that "the company must both emphasize growth and efficiency. For example, the computer business

prices are falling; therefore, our costs must come down faster to offset this price erosion."

We are monitoring closely Diceon's debt to equity ratio using market capitalization as a useful proxy for true equity. We will feel more comfortable when this ratio begins to fall from its present 4.51:1.

The company's cash position is still ample, and cash flow remains positive despite continued operating losses.

Diceon Electronics is still recommended as a high yield choice in a balanced portfolio.

We presently offer Diceon Electronics 5½%, 1/3/12 at a price to yield 16.91%.

Chart 17

### Recommended bond portfolio allocation for new portfolios

For new portfolios, we recommend the following investments:

Finnish Markka fixed rate bonds	15%	Argentina BICV	22%
Italia Lira fixed rate bonds	25%	New Zealand 5 year Govt. Stock	13%
US \$ high yield CV bonds	25%		

Chart 18

### 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, DKr, BP, FFr, ECU, CD, SAR, ITL, ARG, FIN) or revalue for SF or JY before the interest rate advantage/disadvantage is overcome by currency depreciation/appreciation. Rates as of Thursday, February 25, 1993.

	U.S. \$	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	3.28%	C.B.A. '94 yields 6.51% (1.6731 A\$/US)									ESCOM 11% '93 yields 11.76% (.2041 US/SAR)			
2 year	3.96%					Denmark '94 yields 10.55% (7.062 Dkr/US)						GE '95 yields 10.78% (1.785 ITL/US)		Finland '95 yields 8.96% (6.53 FM/US)
3 year	4.35%				World Bk '96 yields 3.54% (114.63 US/JY)		Sweden '96 yields 6.78% (1.339 BP/US)					NIB '96* yields 11.02% (1.893 ITL/US)		
4 year	4.75%		World Bk. '97 yields 6.57% (1.743 US/DM)					Credit Lyonnais '96 yields 8.37% (6.34 Ffr/US)		RBC '97 yields 8.09% (1.421 US/CD)				
5 year	5.15%									Eksport finans '97 yields 7.69% (1.412 US/CD)				
6 year	5.48%			Australia '98, yields 4.79% (1.451 US/SF)										
8 year	5.66%								UK. '01 yields 7.86% (.993 ECU/US)				BICV '01 yields 21.40% (.330 US/ARG)	
Spot Exchange Rate	-	.6942	1.627	1.509	117.35	6.245	1.435	5.534	1.1879	1.253	.2209	1.572	.99	5.945

\*For example, since a US\$-based investor would receive 667 basis points (1102-435) by holding the NIB Italian lira bond, the ITL/US can depreciate to 1.893 ITL/US from the present spot exchange rate of

1.572 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.

Chart 19  
FOREIGN CURRENCY BONDS

Date: February 25, 1993

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
<b>DEUTSCHE MARK DENOMINATED</b>				
BANK OF NOVA SCOTIA 5 5/8% 07/05/96 RRSP eligible	96	-	-	May 07
WORLD BANK 5 7/8% 4/02/97 RRSP eligible	99.45	100.20	5.81%	Feb.04
WORLD BANK 9% 13/11/00 RRSP eligible	113.50	114.25	6.57%	Nov.13
<b>FINNISH MARKKA DENOMINATED BONDS</b>				
REP. OF FINLAND 11% 15/6/95	103.76	104.51	8.96%	Jun.15
<b>ITALIAN LIRA DENOMINATED BONDS</b>				
NORDIC INV. BANK 12 3/8% 19/04/96	102.60	103.35	11.02%	Apr.19
GENERAL ELECTRIC 11 1/2% 7/02/95	100.40	101.15	10.78%	Feb.07
<b>SWISS FRANC DENOMINATED BONDS</b>				
GOVT. OF AUSTRALIA 5% 30/10/98	99	101	4.79%	Oct.30
<b>DANISH KRONE DENOMINATED BONDS</b>				
KINGDOM OF DENMARK 9% 15/11/94	96.85	97.60	10.55%	Nov.15
<b>ECU DENOMINATED BONDS</b>				
UNITED KINGDOM 9 1/8% 21/02/01	106.55	107.30	7.86%	Feb.21
<b>BRITISH POUND DENOMINATED BONDS</b>				
KGDM OF SWEDEN 8 3/4% 29/5/96	104 3/4	105 1/2	6.78%	May 29
<b>FRENCH FRANC DENOMINATED BONDS</b>				
CREDIT LYONNAISE 9 1/2% 23/12/96	102 3/4	103 1/2	8.37%	Dec.23
<b>JAPANESE YEN DENOMINATED BONDS</b>				
WORLD BANK 5 3/4% 7/8/96 RRSP eligible	106 1/2	107	3.54%	Aug.07
<b>CANADIAN DOLLAR DENOMINATED BONDS</b>				
ONTARIO HYDRO 10 7/8% 08/01/96 (semi annual)	108	108 3/4	7.54%	Jul.08
EKSPORTFINANS 7 3/4% 5/11/97	99 1/2	100 1/4	7.69%	Nov.05
ROYAL BANK OF CANADA 9 1/8% 7/1/97	102 1/2	103 1/4	8.09%	Jul.07
<b>SOUTH AFRICAN RAND DENOMINATED BONDS</b>				
ESCOM 11% 31/10/93 (semi)	98.95	99.70	11.76%	Apr.30
<b>AUSTRALIAN DOLLAR DENOMINATED BONDS</b>				
COMMONWEALTH BANK OF AUSTRALIA 14% 01/07/94	108 3/8	109 1/8	6.51%	Jul.07
<b>ARGENTINEAN PESO DENOMINATED BONDS</b>				
ARGENTINA BIC V FIXED/FLOATING 1/05/2001 callable in full on any interest date	86.70	87.45	21.40 IRR	4th day of mth.
<b>U.S. DOLLAR DENOMINATED FIXED CONV. BONDS</b>				
DATAPOINT CORP. 8 7/8% 1/6/06 CV @ \$18.11 p/sh (semi)	74 3/4	76 3/4	12.90%	Jun.01
DICEON ELECTRONICS 5 1/2% 1/3/12 (semi) CV @\$39.50 p/sh	35 1/2	37 1/4	16.91%	Mar.01
BURNUP & SIMS 12% 15/11/00 (semi) CV @\$16.79 p/sh	88 1/2	90 1/2	14.54%	May.15
ATARI CORP. 5 1/4% 29/4/02 CV @\$16.31 p/sh	48 1/2	50	16.00%	Apr.29
COEUR D'ALENE 6% 10/6/02 CV @\$26.56 p/sh	80	81 1/2	9.02%	Jun.10
COEUR D'ALENE 7% 30/11/02 CV @\$15.87 p/sh (semi)	105	106 1/2	6.20%	May.31
<b>U.S. DOLLAR DENOMINATED FIXED RATE BONDS</b>				
FARM CREDIT CORP. 7 3/4% 10/06/96 RRSP eligible	108.48	109.22	4.63%	Jun.10
<b>U.S. DOLLAR DENOMINATED FLOATING RATE NOTES</b>				
UNITED KINGDOM 24/09/96 3 mo.LIBID-1/8 (qtly)*callable @ 100		99.70 100	3 1/4	Mar.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

**HOTLINE UPDATE**

**Tuesday, January 26:**

The market letter is in the mail, and there are no changes or new recommendations.

**Friday, January 29:**

There are no changes or new recommendations.

**Tuesday, February 2:**

There are no changes or new recommendations.

**Flash Update, Wednesday, February 3, 10:15 a.m.:**

Sell June Nikkei Dow traded on the CME at the market, presently trading at 17,380. Place initial stops at 18,500, close only. We also recommend the purchase of Japan index put options 170 through 150 striking, traded on the American Stock Exchange.

**Flash Update, Friday, February 5, 9:00 a.m.:**

Buy March D-mark at the market, presently trading at .5995. Place stops at .5955, close only.

**Friday, February 5:**

This is a recap of recommendations for the week. On Wednesday, via flash update, we recommended to sell June Nikkei Dow traded on CME at the market, placing initial stops at 18,500, close only; also to purchase Japan index put options 170 through 150 striking, traded on the American Stock Exchange. On Friday, February 5, via flash update, we recommended to buy March D-mark at the market, placing stops at .5955, close only.

**Tuesday, February 9:**

There are no changes or new recommendations.

**Flash Update, Wednesday, February 10, 5:00 p.m.:**

Buy June gold at the market. Place initial stops at 328.50, close only.

**Friday, February 12:**

This is a recap of recommendations for the week.

On Wednesday, February 10, via flash update, we recommended to buy June gold at the market; place initial stops at 328.50, close only. Also, there are two new recommendations: First, liquidate long S&P futures positions as

well as long call options; and second, initiate new short positions in the S&P via the purchase of June 440 and 445 put options.

**Tuesday, February 16:**

There is a new recommendation to liquidate long March FTSE positions at the market.

**Friday, February 19:**

This is a recap of recommendations for the week.

On Tuesday, February 16, we recommended to liquidate long March FTSE positions at the market. Also, there is one new recommendation today: Liquidate long D-mark, short British pound cross at the market.

**Tuesday, February 23:**

There are no changes or new recommendations.

**Friday, February 26:**

This is a complete summary since our last market letter dated January 24 of all liquidations of open positions and new recommendations that remain outstanding.

On Wednesday, February 3, via flash update we sold June Nikkei Dow traded on CME at approximately 17,320, placing initial stops at 18,500, close only. Also we bought Japan index put options 170 through 150 striking traded on the American Stock Exchange at 4%.

On Friday, February 5, via flash update, we bought March D-mark at approximately .5996 and placed stops at .5955, close only.

On Wednesday, February 10, via flash update, we bought June gold at approximately 334.00 and placed initial stops at 328.50, close only.

On Friday, February 12, we liquidated long March S&P futures positions at approximately 433.80, as well as all outstanding call options positions and initiated short positions in the S&P, via the purchase of June 440 put options at approximately 9:30.

On Tuesday, February 16, we liquidated long March FTSE positions at approximately 2811.

On Friday, February 19, we liquidated long D-mark, short British pound cross at approximately 237.29.

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