

FRIEDBERG'S

COMMODITY & CURRENCY COMMENTS

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Range Trading

Except for two very brief episodes the DM/\$ rate has been comfortably confined to a DM/\$1.50 – DM/\$1.70 range for the better part of the past 40 months. This remarkable stability is a function of the nearly equal *lack of appeal* in holding assets denominated in these currencies.

Cyclical considerations favor the US dollar; Germany finds itself in the worst post-war recession, saddled with an incredibly unproductive new region while the US continues its halting recovery, certain to pick up momentum in the second half of the year. Interest rates, on the other hand, favor Germany as three month rates are as much as 400 basis points higher. Both Central banks are unreliable guardians of purchasing power, having permitted inflation rates of 4%-5% per annum, though the Bundesbank talks tougher and has a far better long term performance. Both treasuries are profligate, running huge fiscal deficits, though Bonn has begun to face the mounting and wearying costs of reunification via the more benign method of spending costs.

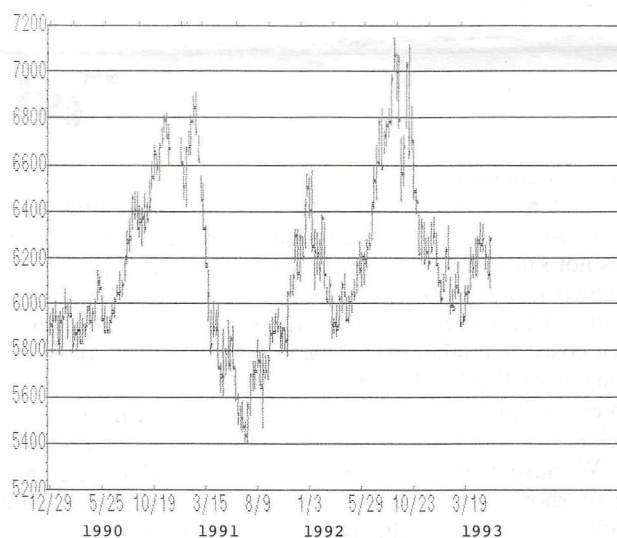
On the labor front, Germany is relatively worse off: Strong unions, able to obtain excessive benefits, which are reflected in still-rising unit labor costs and frequent work-stoppages. And while both nations are running prospective current account deficits for 1993-94, the US at 1½% of GDP and Germany at an 2% of GDP, the former is a function of the recession while the latter is more indicative of an "overvalued" currency.

Summing it all up, neither is sufficiently attractive to rise in a trend-like fashion *vis à vis* the other. This is not new to our readers who have been told, month after month, that, *at best*, the US dollar will appreciate in *real* terms as inflation differentials widen *vis à vis* Germany. The risk to the dollar lies in the failure of the Fed to act.

Near term, the DM and its satellites may strengthen a bit further as the Bundesbank, again, begins to worry about M3 (reaccelerating) and the stubbornness of inflation. Medium term, however, the Fed *should* react to inflation fears in the US whether real or perceived (more on that in our interest rates section), raise interest rates, and avoid a severe dollar sell-off. The market will tend to move to minor "extremes" accompanied by euphoria hither and thither as breakouts appear real: The chart chorus will sing but the emanating sounds will be flat. For, in truth, the DM/\$ rate deserves to stay range-bound.

STRATEGY: *Victory is to the nimble: which translates into: trade with the trend... for only a few hours. Or, better yet, fade the occasional euphoria.*

Chart 1 – CME DEUTSCHE MARK



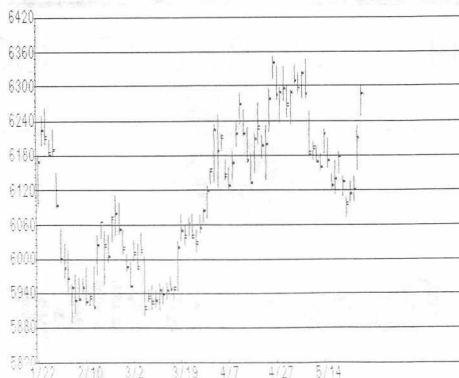
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Contributions by Albert D. Friedberg, Dr. Steve H. Hanke, Neil Reynolds, Edison Lee, David B. Rothberg, and Michael D. Hart.

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

CHART 2 – CME DEUTSCHE MARK JUNE 93



INTEREST RATES

Fed misses!

The fed misses the point — on two scores!

First, as we've been pointing out ad nauseam, inflation is accelerating. It is not to be found in brand products (who does not know, by now, that Marlborough prices have been chopped!), not in raw industrial prices (who has not read about the multi-year lows in the base-metals), not even in labor costs (unit labor costs, which always lag, have been flat to negative). But it is found in administered prices and other non-competitive prices, (taxes, insurance, medical costs), stock prices, and gold.

We have been so impressed with Chart 4 that we do not tire of showing it. The "line of best fit" summarizes the relationship between the rate of monetary expansion (as measured by our old trusty friend, M1) and inflation. Given M1's four-year rate of growth (to IVQ 1992) of 6.7%, consumer prices should be increasing at an annual rate of 5.8%. Recent monthly readings are starting to confirm this neat and simple forecast.

With the exception of two members, the governors of the Fed have turned a blind eye to telltale signs that their monetary policy has been much too lax. Stock prices have risen well beyond reasonable levels, short-term interest rates have been negative for quite a few months, and lately, bond prices have fagged while gold prices have mounted an unusually

strong rally. Instead, the governors have continued to point to weak economic activity numbers (as if that has anything to do with inflation) and well-behaved unit labor costs.

They are wrong on this score. The rapid four-year pace of M1 and negative short-term rates practically guarantee that inflation will become, if not next month, surely by late 1993, a serious problem.

And by explaining away rising gold prices (as being due to "special factors" such as Chinese buying) they are making a second mistake. Inflation is not only what is but what is perceived. And that is because expectations, via their effect on velocity, are as serious a problem as actual money growth. A speed-up in M1 velocity accompanied by excessive rates of growth of M1 can easily compound the problem. Conversely, resolute and firm action on the part of the Fed could slow down M1 velocity and cancel some of the inflationary implications of rising money growth.

In short, what really matters is not what the Fed thinks, but what the public thinks. And since gold, foreign exchange, and bond yields are the best gauge of public expectations, it would appear but inevitable that the Fed's next move in rates is UP.

STRATEGY: Continue to accumulate T-bond put options, moving now to March 1994, where possible.

Chart 3 – CBT T-BOND (DAY) SEP '93

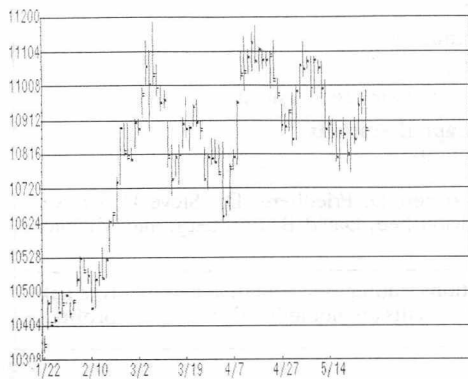


Chart 4

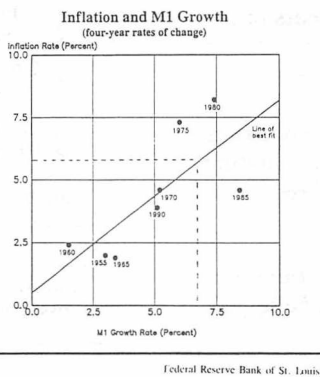
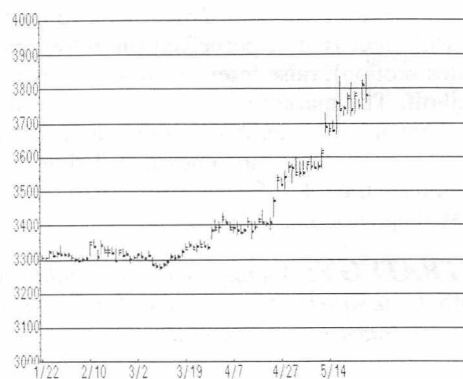


Chart 5 – COMEX GOLD JUN '93



EUROPE

Reflections on The ERM

The January/February 1992 issue of *The International Economy* carried a piece titled "A Realignment Tranquilizer" by Sir Alan Walters and me. We made the following points about the EC's Exchange Rate Mechanism (ERM). (1) It was an unstable monetary regime; (2) unless it was realigned, it was headed for a crisis; (3) it was fatally flawed and could not be permanently repaired; (4) hence, it should be junked. In consequence, we were subjected to considerable intellectual terrorism from the EC powers in Brussels. But, by the time the exchange rate crisis of September 1992 rolled around, the folks in Brussels had discretely folded their tents. Alas, there is no graceful way of saying we told you so, but the truth of the matter is that we did.

Last week, the EC monetary committee issued a report on the ERM exchange rate crisis of last year. The report concluded that there is nothing fundamentally wrong with the ERM. Although we disagree with that conclusion, it is important to mention that the report recommends more frequent exchange rate realignments and only limited central bank support of individual currencies, even when they come under speculative attack. Those last two points represent major changes — in the right direction we might add — in the EC's position. That said, most professionals (at the EC and elsewhere) and pundits remain completely confused about alternative exchange rate regimes and their economic implications. Our task is to clarify those alternatives, draw some implications, and outline trading strategies.

Exchange rate regimes come in three generic varieties.

First, there is the *free-floating exchange rate type*, where the government does not intervene to influence exchange rates. (There is also the "dirty float," where the government does intervene, but not with a specified target in mind.)

Second, there is the *absolutely fixed exchange rate type*. This is where the rate is allowed to deviate only by some small margin (e.g., the gold points under the old gold standard) from a specified party. Usually, fixed exchange rates are associated with an automatic redemption arrangement, such as the currency board in Hong Kong. The parity is never to be changed — except for some *force majeure* such as total war.

Third, there is the *pegged exchange rate type*. It includes a menagerie of forms, including "crawling pegs," "fixed but moveable pegs," (e.g., the ERM), etc. In this case, the government undertakes to keep the exchange rate within a "band" around a central value, and the central value is not fixed. Indeed, it is referred to oxymoronically as a "fixed but flexible" system. It is accepted, with differing degrees of commitment, that the control value will be moved under conditions of (fundamental) "disequilibrium." In practice, the central value usually moves because the government cannot hold it except with measures that are "politically impossible."

Under the free floating and the absolutely fixed exchange rate type, central banks have no discretion *vis à vis* the exchange rate. However, under the pegged type, the government or the central bank has discretion about when to

be pegged and when to be flexible. Much to the dismay of the authorities, currency speculators know that this discretion exists under pegging systems. Consequently, they play on that fact for large stakes.

The effects on monetary policy of the three systems are also quite different. If the exchange rate is floating, then it is possible for the countries that have floating rates to pursue their own monetary policies. The exchange rate will adjust to ensure that people are just willing to hold the stocks of money so created. (We assume no exchange controls.)

If the exchange rate is fixed, there can be only one monetary policy. For example, the monetary policy of Hong Kong is determined by the Federal Reserve Board of the United States because the Hong Kong dollar is absolutely fixed to the US dollar. That fix is credible because the currency board in Hong Kong must back the Hong Kong dollars it issues by US dollar reserves of 100% and there is full convertibility (no capital controls).

The superficial attraction of pegged exchange rates is obvious — somehow the authorities think they are getting the best of both worlds, namely stability of nominal exchange rates and the flexibility to move them when tradeable goods prices and cost get out of line. (The original documents on the ERM in 1978 indicate that their authors believed that the system would give rise to an "area of stability" in exchange rates.)

However, with a pegged exchange rate type, responsibility is muddled and diffused. A pegged country can have a bit of a monetary policy, allowing the exchange rate to wander within the band, and on occasion moving the band to a new central value. Indeed, it is the equivocation of monetary policy that causes much of the trouble with the pegged system.

Even with the pegged system's troubles, such as those we witnessed in September 1992, many argue that those troubles are worth their costs because the pegged system provides discipline. Indeed, the proponents' case for a pegged exchange rate is that it gives rise to a discipline which prevents runaway inflation and provides an effective containment of excess wage pressures. Furthermore, it is argued that fiscal reforms, again with the peg as the critical discipline, can be tackled and burgeoning budget deficits can be controlled.

If it were true that the fixed-but-flexible system gave considerable impetus to these reforms, it would be a powerful case for some sort of peg. The evidence on this proposition is, however, rather equivocal. For example, Italy has been pegged in the ERM since 1979, and to say the least, there has been no noticeable improvement in its fiscal balance, nor in its unsustainable welfare payments. Certainly since Britain joined the ERM, informally in February 1987 and formally in 1990, the fiscal position has deteriorated alarmingly. Indeed, in terms of performance on almost all indicators, the British government behaved itself far better when out than when in the ERM. Nor has membership of the ERM helped Belgium to reduce her government debt — now much more than its GNP. As for Spain, fiscal rectitude under

the ERM discipline has been as elusive as the Holy Grail. Indeed, if we look at Europe as a whole, budget deficits were on average -3.0% during the 1987-89 period. Then, after every country became firmly wedded, either formally or informally, to the ERM, the deficits steadily increased: they were -4.3%, -5.4%, and -6.7% in 1991, 1992, and 1993, respectively.

But if, in spite of these examples, the Europeans still believe that a pegged rate does give rise to effective discipline, then surely they should consider an absolutely fixed rate instead of the peg. This could be achieved by abolishing the money-creating monopoly of the Central Bank and instituting a currency board. The board would simply exchange domestic currency for the reserve currency at a fixed rate with a small spread sufficient to finance the board's expenses. The board would be required to hold reserve currency assets equal or greater in value than the value of domestic notes it issued. The board would not be able to engage in a discretionary monetary policy. Hence, it could not finance fiscal deficits. The board would earn seignorage because its liabilities (domestic note) would not pay interest; whereas, its reserve assets would earn interest.

The advantages of the currency board fix over the ERM peg are clear. There would be no speculative capital flows in anticipation of a change in the peg — such as occurred in September 1992. A currency board country would have the same interest rates, if for example the reserve currency was the deutschemark, as Germany. Also, the transparency of the currency board system is in marked contrast to the shenanigans of pegged systems.

So, if Europeans believe external discipline is good, then they should adopt a currency board system and fix all European exchange rates to a reserve currency. If they believe that a country can responsibly control its own fiscal-monetary destiny, then it should float. Alas, Western Europe wants it both ways, and is burdened with the worst type of exchange rate regime — the pegged system. In consequence, Western Europe will have to continue to endure the pain of an industrial slump that will be much deeper and longer than most now expect. Furthermore, Western Europe will witness more currency realignments in the coming months. Backed by the

EC's new report, those "competitive devaluations" will be blessed by the gods who reside in Brussels.

— Dr. Steve H. Hanke

STRATEGY: *Our managed accounts are participating in the current ERM turmoil with long Italian lira/short Spanish peseta, and long German mark/short French franc trades. Both positions should be retained. For the rationale, let's look at the short side of those crosses.*

Spain is in deep trouble. Its industrial slump became severe in the fourth quarter of 1992, and the pace of the downturn accelerated in 1993. Unemployment has soared to almost 22% and is going higher. The fiscal deficit measured as a percent of GDP is already double that required by the Maastricht budget deficit criterion of 3% and monetary policy, which is driven by the ERM, is restrictive. In the short run, the only way to obtain relief is to allow for a further (it would be the fourth since last September)" competitive devaluation," that will occur after the election of June 6. Indeed, after that date the peseta could well be trading at 85 on a DM/peseta basis. In the long run, the only way Spain can regain economic health is to adopt a set of radical supply-side policies that will improve labor market flexibility and create jobs.

France, too, is in deep trouble. With a budget deficit of 5.1% of GDP, it is exceeding the Maastricht criterion, and driven by the ERM it has a very restrictive monetary policy. The economy is in a slump and unemployment is 11% and rising (and that doesn't include about 1.5 million make-work jobs created by the government). Mr. Balladur's new government has almost no manoeuvring room. Just for France to absorb new entrants in the labor market, it has to grow almost 2.5%. Hence, in the short run, it must let the Franc slip vis à vis the DM.

In the long run, it must also adopt a set of radical supply-side policies to regain economic health. However, even though France's unemployment record has been the worst of any large OECD country since 1973, Mr. Balladur's government has been unwilling to embrace supply-side reforms. Indeed, his government has recently introduced new taxes that promise to aggravate France's endemic supply-side problem.

JAPAN

Death spiral

The relentless climb of the Japanese yen is devastating exporters' profits and putting unbearable deflationary pressure on the economy. In an almost futile attempt to stop the bandwagon, the Bank of Japan has been intervening rather heavily: External reserves rose by \$6.9 billion from a month earlier to \$76.9 billion at the end of April. This was the third largest rise ever. The BOJ started buying in early April when the dollar broke below ¥114 but the yen has continued to climb and now stands at 107.

Inevitably the BOJ will have to ease and ease significantly, to combat these deflationary forces. The job has been made all the more difficult by the government's manipulation of ex-

pectations: pushing stock prices and forecasting that an economic turnaround is just around the corner. As a result, long-term interest rates have risen an astounding 20% to a recent 4.7% while the long-term prime rate has risen twice to 5.4%. Unsterilized intervention should do the trick. Will the BOJ have the will?

STRATEGY: *We continue to believe that low interest rates are in store. Euro-yen call options and long futures should prove very profitable. Despite our conviction that interest rates are heading much lower, stock prices too should head considerably lower, challenging the 15,000 low registered last year.*

Chart 6 – SIMEX EUROYEN SEP '93

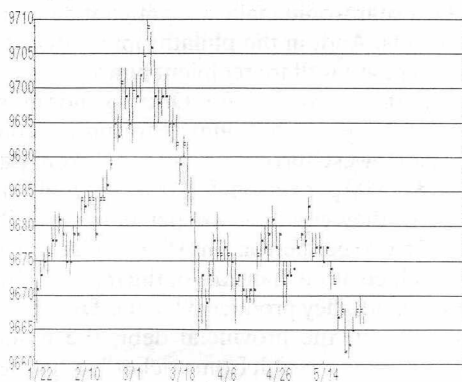


Chart 8 – CME JAPANESE YEN JUN '93

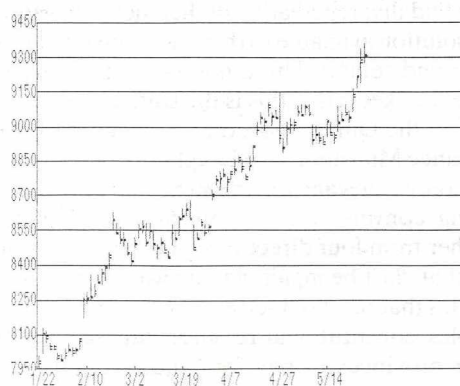
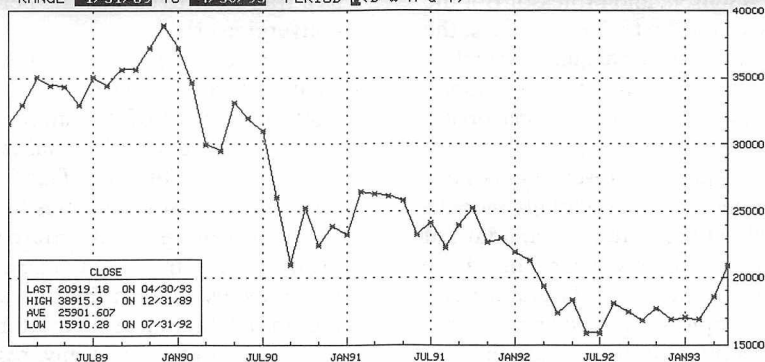


Chart 7

PRICE GRAPH for NKY -- NIKKEI 225 INDEX
 RANGE 1/31/89 TO 4/30/93 PERIOD (D-W-M-Q-Y)



Courtesy: Bloomberg

CANADA

Canada in debt

The biblical prophets were all market analysts in one way or another. They especially excelled in identifying market peaks and in denouncing the economic excesses that accompanied them. They speak to us across the centuries because the human tendency to cyclical excesses hasn't noticeably diminished. People and governments still move from licentious acquisition to woeful repentance, from fine robes to sackcloth. People and governments still go too deeply into debt to acquire goods and services that are too highly appraised. These debts are still weighed in the scales against real, disposable incomes; and, with prophetic regularity, they are still periodically found wanting.

Habakkuk, for example, marvelled at the dynamic commerce of the Assyrian Empire — “thy merchants,” he said, “multiply more than the stars of Heaven.” Yet he knew that Assyria’s great prosperity could not survive the swarms of bureaucratic “locusts” that issued from Ninevah. And he knew that Babylon’s legendary wealth could not survive the vast public debt of its ostentatious rulers: “Woe to him that laden himself with pledges!” he proclaimed. “Shall they not rise up suddenly and bite thee?”

Talk about a downgrade of government debt. This one reduced Babylonian bonds to a “woe rating.” Habakkuk, though, was only a minor prophet and he could be ignored by Babylon’s finance ministry — precisely as the Canadian Bond

Rating Service was ignored in April by Canada’s finance minister, Donald Mazankowski. The DBRS downgrade of Canadian government bonds meant nothing, Mr. Mazankowski said; further, he said, DBRS was a minor prophet.

In fact, however, the minor prophet is quite right. The consequences of excessive Canadian debt — personal debt as well as public debt — are beginning to converge with dramatic force. The political and economic impact will be profound; the survival of the Canadian federation itself hangs in the balance. In comparison with Canada’s debt obligations, a secessionist Quebec must now be rated as a secondary threat to Canadian nationhood.

The markets are mostly concerned with only one aspect of Canada’s debt crunches — the ability of the federal and provincial governments to make their interest payments on government bonds. The DBRS downgrade of federal bonds is an early portent of things to come; the major prophets, however, have signalled comparable judgments of their own. Now University of Alberta economist Paul Boothe, who has extensively studied Canadian government debt, says that Canada’s *richest* provinces confront the prospect of “severe” debt crises.

Professor Boothe believes that these crises are inevitable; even a complete freeze on public spending, he says, will

not avert them. He says that some of the provincial governments could find that repudiation of their debt obligations will be the only solution available to them: explicit declarations of bankruptcy and default. This is not the stuff of the usual Canadian money market crisis; this is the stuff of Judgment Day.

Did the Ontario government meet market expectations in Finance Minister Floyd Laughren's budget on May 19? The question is relevant for the next few days but it misses the coming convergence of Canada's *real* crises. They come together from four directions: (1) excessive structural public debt that can't be manipulated away; (2) counter-productive tax rates that must reduce economic activity; (3) devious and complex constitutional requirements that require Canada's richer provinces to pay for "equal" public services in the poorer provinces; and, with convergent impact upon the people who sustain these practices, (4) alarming increases in the personal debts undertaken by Canadian households.

Mr. Mazankowski, Mr. Laughren, and professor Boothe speak in their own ways only to the first of these crises, the structural public debt; the markets are well acquainted with it. The consequences of rising tax rates, however, can be appreciated only within the context of Canada's constitutional obligations to "share" and Canadian households' acquisition of debt.

In essence, here's what happened. Governments have incrementally increased their debt by incrementally increasing taxes. People have maintained their after-tax standard of living by borrowing; further, in the past year, they have borrowed long-term, using their homes as collateral for current consumption. Yet these people — homeowners — are precisely the people whom governments are now targeting as "the rich" and upon whom they are now imposing punitive *further* tax burdens. These homeowner-directed tax increases are now rising dramatically because provincial governments are legally able to levy taxes only upon property.

In this crunch, Canada's "fiscal federalism" — the share-the-wealth transfer payments that, more than patriotism, hold Canada together — has collapsed. In April, the C.D. Howe Institute published a fine report on *this* crisis. Political scientist Peter Leslie says that Canada's fiscal crisis will soon, *by itself*, force "a sharp curtailment" in transfer payments, with the certain destruction of the country as a "sharing community." Political resistance, moreover, will also suffice, *by itself*, to produce the same result. He describes the risks as "urgent." Economist Kenneth Norrie concludes that Canada must act soon to "avoid a breakdown of the system." Economist Irene Ip calls for "immediate" and comprehensive reform.

Canadian "fiscal federalism," however, is defined by constitutional statute. Parliament must ensure enough transfer of wealth across the country "to provide reasonably comparable levels of public services at reasonably comparable levels of taxation." The details must be negotiated by the federal government and all of the provinces. Any series of federal-provincial negotiations on Canada's system of transfer payments will produce strains comparable to the constitutional agonies of 1992, and perhaps worse. On this rock, Canada risks going aground with a passenger list formed exclusively of provincial treasure-seekers.

Ontario, British Columbia, and Alberta provide the funds for Canada's elaborate sharing of the wealth. On a per-capita basis, Ontario pays \$1,250 a year; each family of four, in other words, pays \$5,000 a year. This is remarkably charitable or a

province that confronts certain fiscal crisis; for most Ontario families, \$5,000 a year would make a significant dent in their mortgage payments. And, in the philanthropic province, one person in eight is now a welfare recipient himself or herself.

As great as this burden is for Ontario, however, the reliance upon it in the rest of the country is disproportionately greater. In the Northwest Territories and the Yukon, transfer payments equal \$16,000 per person, \$64,000 per family of four. In Newfoundland, they equal \$4,400 per person; in Prince Edward Island, \$5,000 per person. In Atlantic Canada, transfer payments produce more than 20% of the region's GDP; in Prince Edward Island, they produce 32% of GDP.

The federal debt, the provincial debt, the municipal debt, the vast transfers of wealth from "richer" to "poorer" — all of these burdens fall on a relatively fixed number of taxpayers. Bank of Canada debt statistics indicate that many people are coping by gambling on long-term mortgage debt as a trap door to escape the personal consequences of these converging crises.

Canada's chartered banks, for example, report only a small increase in consumer borrowing during the past year: 1.5% (an increase of \$992 million to \$666 billion). They report a 16% increase in residential mortgages (an increase of \$19 billion to \$136 billion). This increase reflects, in part, the takeover of trust companies by chartered banks in the past year. The same general pattern holds, though, for all lending institutions — trust companies, credit unions, etcetera. And the statistics confirm the trend. Homeowners are going further into debt even as their after-tax incomes are falling.

In the entire economy, residential mortgage debt now exceeds \$300 billion; consumer-credit debt, \$100 billion. In its 1992 annual report, the Bank of Canada confirmed that the rise in residential mortgage debt reflected a conversion of consumer debt into mortgage debt; the bank, though, did not appear too concerned. Debt consolidation often makes good sense, and especially when mortgage interest rates are low. It is one way for families to get their debt, and their monthly payments, under control.

When the process merely represents debt conversion, then, it may be benign or beneficial. This straight-forward process, however, should produce a corresponding decrease in consumer debt as people draw upon their mortgage funds to pay off credit cards and consumer loans. In fact, total household credit is rising; it increased by 2 percentage points between 3rd Quarter '92 and 4th Quarter '92. In the same quarters, the ratio of debt to after-tax income rose (though only slightly; after-tax income declined from \$479.1 billion to \$479.0 billion).

The process here is obvious. The Bank of Canada notwithstanding, the risks are equally obvious. Having mortgaged their only significant asset closer to the limit, many people will again run up their charge cards; property taxes and wealth taxes will consume more of homeowners' declining incomes; and real estate values may — or may not — be fully discounted from the excessive appraisals of 1989-90. Central Mortgage and Housing Corporation already owns 10,000 repossessed homes. The convergence of political and economic crises in Canada suggests that it will take over many more in the year ahead. On the margin, Canadian homeowners are vulnerable; and the margin is the one part of the Canadian economy that is really on the move.

— Neil Reynolds

CANADIAN DOLLAR

Prospects dimming

For one thing, the Ontario government's so called "social contract," negotiations with its own public sector employees to obtain saving of about \$2 billion, is floundering. If, in the end, the militant unions go along with the socialist government's request, they will demand and obtain in return concessions that will be many times worse — on a microeconomic level — than the damage that can be wrought on the economy by a few billion dollars more of deficit financing. An exodus of capital is to be expected.

Secondly, provincial government deficits are bound to get slightly smaller after savage tax increases and light spending reductions, with two important consequences: 1) the economy will suffer, investment plans will be cancelled and long-term capital will emigrate, putting pressure on the Canadian dollar and 2) provincial borrowing, at the margin, will

diminish somewhat, removing an important source of foreign exchange inflows (see Chart 10).

The Canadian dollar is particularly *vulnerable* at this time because short-term interest rate differentials have narrowed to five-year lows (170 basis points), and because the upcoming election campaign will be featuring a Liberal party bent on promoting growth even at the expense of a "little bit" more of inflation.

Poor economic prospects and their effect on investment, before an election that may change the rules of the game (*vis à vis* inflation, free trade, intervention) and superimposed on a currency that has lost its most potent and only attraction, i.e., high yield, make for a good bearish case.

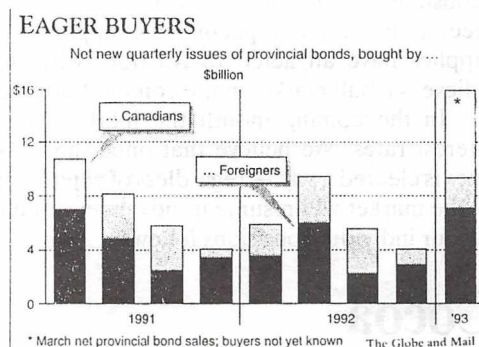
STRATEGY: Sell September '93 Canadian dollar at market, place initial stops at 79.50.

Chart 9



Courtesy: Bloomberg

Chart 10



* March net provincial bond sales; buyers not yet known The Globe and Mail

LONG LIRA/SHORT STERLING

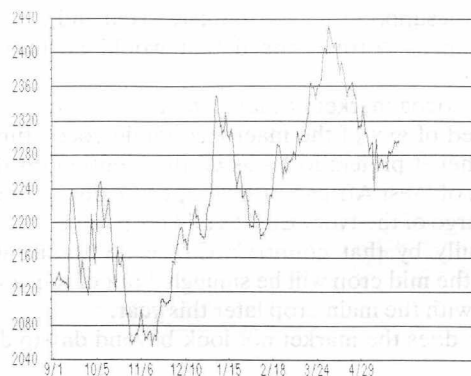
Coming back our way

Unfortunately, we lost Amato. Instead we got a new, transition government headed by a central banker intent on some house-cleaning chores but missing imagination, salt and pepper. Worse yet, there are no more government scandals.

Chipping away at the deficit in small increments uses up a great deal of political good will, sapping away the energy needed for the big and bold moves. We are referring to massive privatization, of course.

Let's give him a chance, though.

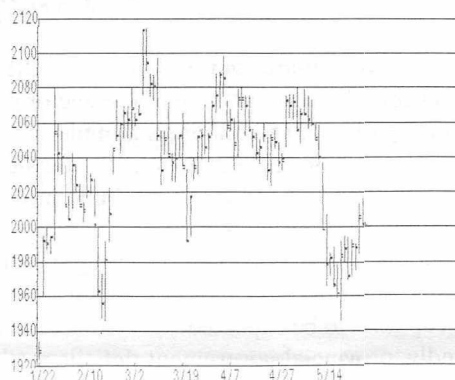
Chart 11 - LIRA PER £



CRUDE OIL

STRATEGY: Continue to maintain aggressive short positions; roll forward expiring futures and puts.

Chart 12 – NYME CRUDE LIGHT JULY '93



COMMODITIES

Commodity prices have held at around levels achieved last month. The CRB (Commodity Research Bureau) index benchmark, currently at 208.69 is down .39% since last writing. Ongoing reports of sluggishness in the US economy, anxiety that rates — especially at the long end of the market — would rise in response to the 5% annual rate of increase in the CPI (Consumer Price Index) reported in April, profit taking in precious metals, and speculator disappointment about grain supplies have all acted to frustrate what we continue to believe is a bull market in the commodities sector.

In the coming month the market's focus will be on interest rates. We believe that once the uncertainty about rates is cleared away — regardless of whether rates rise or not — the market will resume its advance. Commentary regarding our individual positions follows:

Cocoa

Last week statistician E.D. & F. Man forecast a deficit in the upcoming 1993-94 crop year, which begins in October. Man predicts the deficit will result from steady increases in consumption in traditional consuming nations and a somewhat surprisingly robust demand pattern beginning to assert itself in Eastern Europe.

(In September of 1991 we predicted that in response to years of extremely low prices, consumption would increase at an average rate of 4% throughout the decade; too high to be met by a supply structure unlikely to expand).

If Man is correct, the deficit would be the third in succession.

The cocoa market has taken no heed of Man's forecast, nor indeed of any of the macroeconomic cocoa fundamentals. Rather it prefers to focus all its attention on the sales positions of West African origins; specifically upon whether the embargo of the Ivory Coast's mid crop will be maintained successfully by that country's Caisse de Stabilisation, or whether the mid crop will be smuggled out of the country or bled with the main crop later this year.

Why does the market not look beyond day-to-day busi-

ness toward the supply chasm that must eventually develop? Is the market behaving irresponsibly by not taking into account the long-term fundamentals of cocoa? or are those fundamentals so long term as to be irrelevant? The answer is, so to speak, in inventory.

At the end of the 1990-91 crop year, it was estimated (by the I.C.C.O (International Cocoa Council), Man, and statistician Gill & Duffus) that global stocks represented in the neighbourhood of eight months of usage. Eight months' surplus usage is an overwhelmingly large overhang. It is little wonder cocoa prices fell to \$800 a tonne — the lowest level in real terms since before the Second World War — in March 1991.

In the previous two years the deficits have been of 85,000 tonnes (estimated in 1991-92) and 124,000 tonnes (estimated this year). If usage in the past two years has been 2.3 mln. tonnes (estimated in 1991-92) tonnes and 2.4 mln. tonnes (estimated in 1992-93), then the average monthly rates of usage have been 192,000 tonnes and 203,000 tonnes respectively. Calculated against the deficits of the past two years, stocks should now stand at around 6¾ months of supply.

In 1972 cocoa began a bull market that lasted five years. Prices rose from 20¢ per pound (\$441 per tonne) to \$2.44 per pound (\$5,379 per tonne). The year-end inventory-to-usage ratios from 1970 through to 1975, calculated on a months of usage basis were:

Year	Months of Usage
1970-71:	4.8
1971-72:	4.8
1972-73:	2.9
1973-74:	2.5
1974-75:	3.5

Clearly the current level of 6.75 months of inventory is still burdensome.

The question now becomes: Is the current level of inventory still too burdensome to warrant our holding our position?

For those expecting or hoping for a significant bull market, I would have to conclude the inventory situation is too heavy.

Even if the E.D. & F. Man forecast of a third successive deficit year in 1993-94 proves accurate, the deficit would have to be more than double the 124,000 deficit estimated this year in order to reduce the available months of supply by one.

Where does this leave us? Current prices of \$894 per tonne basis July are just 10% away from the lows reached in June 1992, when supplies represented eight months' usage. In real dollar terms the difference is even less. In other words, our risk at current levels is minimal.

STRATEGY: *I would expect that from current levels prices will appreciate by more than the annual contango (the spread of futures to cash prices) plus inflation. I would advise retaining long positions until a more propitious selling opportunity arises.*

Corn

Futures prices have retreated to the lowest end of the range prices have traded in since last October. The market ignored planting delays in the western part of the corn belt, which includes Iowa. Iowa produced 20% of US corn last year and is traditionally the country's single largest producing state.

The USDA (US Department of Agriculture) estimates the 1993-94 crop at 8,500 mln bushels, virtually unchanged from the 1992-93 crop.

Given that the late plantings will affect nearly a quarter of the 1993 crop — either by encouraging farmers to switch to beans or by reducing yields — and in keeping with our long-held view that corn prices are cheap, we are remaining long with stops at 2.02/bu., basis nearby.

Precious metals

Consensus of opinion surveys showing that bullish sentiment has exceeded 90% for several consecutive weeks, and concern about a rate-rise have led us to conclude that there is enough risk of a shake-out to warrant our taking profits in gold and silver. Our longer-term view remains bullish.

In 1992, for the third consecutive year, silver demand exceeded supply — 88.6 mln ounces. In 1993 the deficit, according to the Silver Institute, is expected to rise to 144 mln ounces. Demand from China and India for both silver and gold is described as "insatiable."

In Australia Dominion (gold) Mines bought back 332,000

previously hedged ounces of gold. It did so "...to expose the company's longer-term reserves and resources to the gold price..." This is the first example I have noted of a mining company viewing a rising gold market as a potential embarrassment — if the price rises to above the price a company has hedged, shareholders will gain no benefit because of the locked-in selling margins — rather than as an opportunity to sell future production into.

STRATEGY: *At this point we see ourselves re-entering the market(s) from the long side on a substantial setback. Stay posted via our Hotline.*

Sugar

The statistical picture of sugar continues to brighten. The I.S.O. (International Sugar Organization), and statisticians Czarnikow, Licht, and E.D. & F. Man all raised their individual forecasts of the size of this year's deficit — to 1.61 mln tonnes, 2.84 mln tonnes, 2.05 mln tonnes, and 600,000 tonnes respectively.

Of significant note is the fact all four forecasts factored Cuban production at in excess of 5.0 mln tonnes. After all four forecasts were published, Cubazucar director Alberto Bettencourt Roa announced that fuel and fertilizer shortages and the tropical storm that attacked the southeastern coast of North America earlier this year had served to reduce the size of his country's crop to 4.2 mln tonnes only.

A supply/demand balance that not six months ago was expected to result in a surplus of 500,000 tonnes could become a deficit of as much as nearly 4.0 mln tonnes.

Furthermore, as we discussed last month, the countries whose diminished production — Cuba, Thailand, and Brazil — has, for the most part, caused the global deficit, are the world's principal exporting countries.

China and India are the other two countries whose sweetener industries have been afflicted by production declines. The former, the world's largest producer, now cannot, as was earlier expected, be relied upon to relieve international tightness. The latter simply adds its production declines to the demand side of the balance.

Sugar prices must rise to ration demand and seduce stocks from inventories that would otherwise be maintained for insurance purposes. Stay long with stops at 1025, basis July.

FRIEDBERG CAPITAL MARKETS

Chiron Corporation

Eurodollar Convertible Subordinated Debenture

Maturity: 5/12/2002

Recent Yield: 9.22%

Convertibility: \$123 per share

Recent stock price: \$61.50

Chiron Corporation of Emeryville, California, is a biotechnology company that focuses on four market segments: diagnostics, vaccines, therapeutics and ophthalmic surgical products. Among its major products are refractive surgical

systems and Proleukin IL-2, a drug approved by the FDA last year that treats metastatic kidney cancer. Other major products produced through joint ventures include a hepatitis C virus (HCV) screening test, which has more than 50% market share and has been used by the American Red Cross; and a vaccine that neutralizes strains of the HIV virus. Also there are various products in clinical trials.

Sales of the company increased 43% in 1991 and 75% in 1992, to \$248 million, mainly because of acquisitions and joint ventures. In the past two years it has acquired Cerus

Corporation, a cancer drug producer, and IntraOptics, Inc., a cataract surgical equipment manufacturer. In addition, it has entered into collaborative research agreements with Ciba-Geigy and joint ventures with Johnson & Johnson to research and develop various drug-related biotech products.

Owing to writeoffs of acquired technology and integration costs, the company lost \$427 million in 1991 and \$103 million last year. With rapid sales growth and higher income from joint ventures, the company is expected to become profitable in '93. First-quarter earnings this year were \$2.5 million, compared with \$50 million loss for the same period in '92. Despite the past losses, the company has a very strong liquidity position, with \$419 million in cash and marketable securities. Just the projected interest income will be more than enough to pay for its projected interest expense in '93. With a very low long-term debt-to-capital ratio (0.18) and total debt-to-market value ratio (0.15), the company also has plenty of debt capacity to cope with future cash needs due to

R&D and joint ventures.

Since Chiron's products and markets have high growth potential and its financial position is very sound, the convertible debenture (\$100 million outstanding) is an attractive buy. The conversion option, which is worth nothing now, may add value to the bond in the future as the company's acquisition and R&D efforts bear fruits.

STRATEGY: *This convertible is attractive, because it represents a long-term call on very exciting technology while paying an above average return. Unfortunately, the bond is highly illiquid: It is either "bid only" (when the bio-tech group is an upswing) or "ask only" (when interest in the group wanes).*

Be prepared to purchase on weakness, paying a maximum of 76 (where it yields just under 9¼%) where the last trade took place (it is now 85 bid). Since trading is very thin, this issue is suitable only for long-term investors who do not have strong liquidity needs.

Chart 13

Recommended bond portfolio allocation for new portfolios

For new portfolios, we recommend the following investments:

Finnish Markka fixed rate bonds	10%	Argentina BICV	22%
Italia Lira fixed rate bonds	25%	US \$ Floating rate Notes	11%
US \$ high yield CV bonds	20%	New Zealand \$ Bonds	12%

Chart 14
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, JY before the interest rate advantage/disadvantage is overcome by currency depreciation/appreciation. **Rates as of Friday, May 28, 1993.**

	US \$	NEW ZEALAND	AUSTRALIAN \$	DEUTSCHEMARK	SWISS FRANC	JAPANESE YEN	DANISH KRONA	BRITISH POUND	FRENCH FRANC	EUROPEAN CURRENCY UNIT	CANADIAN DOLLAR	SOUTH AFRICAN RAND**	ITALIAN LIRA	ARGENTINEAN PESO	FINNISH MARKKA
1 year	3.57%		C.B.A. '94 yields 5.72% (.6726 A\$/US)									ESCOM 11% '93 yields 11.91% (.2003 US/SAR)			
2 year	4.19%					Denmark '94, yields 7.32% (6.4483 Dkr/US)			Credit Lyon '96 yields 6.83% (5.6336 Ffr/US)						Finland '95 yields 7.59% (5.7406 FM/US)
3 year	4.57%			Bk. N.S. '96 yields 6.43% (1.6721 US/DM)		World Bk '96 yields 3.82% (104.94 US/JY)		Sweden '96 yields 7.07% (1.4556 BP/US)			Ont. Hydro '96 yields 7.35% (1.3754 US/CD)		GE '95 yields 9.50% (1.6803 ITL/US)		
4 year	4.94%	NZ '97 yields 6.82% (.5048 NZ/US)		World Bk. '97 yields 5.82% (1.6399 US/DM)							Eksport Fin '97 yields 7.59% (1.4047 US/CD)		NIB '96 yields 10.19% (1.7791 ITL/US)		
6 year	5.52%				Australia '98, yields 4.45% (1.3307 US/SF)										
8 year	5.79%			World Bk '00 yields 6.71% (1.6997 US/DM)						U.K. '01 yields 7.43% (1.086 ECU/US)				BIC V '01 yields 12.96% (1.6886 US/ARG)	
Spot Exchange Rate	—	.5420	.6866	1.5860	1.4179	107.23	6.0779	1.5625	5.3588	1.2283	1.2713	2.164	1.4635	.9993	5.3837

*For example, since a US\$-based investor would receive 525 basis points (1019-494) by holding the NIB ITL bond, the ITL/US can depreciate to 1.7791 ITL/US from the present spot exchange rate of

1.4635 ITL/US over the next 4 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 15
FOREIGN CURRENCY BONDS**

Date: May 28, 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. ANNUAL YLD. TO MTY.	NEXT PAYMENT INTEREST DATE
DEUTSCHE MARK DENOMINATED				
BANK OF NOVA SCOTIA 5 $\frac{5}{8}$ % 07/05/96 RRSP eligible	97.15	97.90	6.43 %	May 07
WORLD BANK 5 $\frac{7}{8}$ % 4/02/97 RRSP eligible	99.40	100.15	5.82 %	Feb. 04
WORLD BANK 9% 13/11/00 RRSP eligible	112 $\frac{1}{4}$	113	6.71 %	Nov. 13
FINNISH MARKKA DENOMINATED BONDS				
REP. OF FINLAND 11% 15/6/95	105.45	106.20	7.59 %	Jun. 15
ITALIAN LIRA DENOMINATED BONDS				
NORDIC INV. BANK 12 $\frac{3}{8}$ % 19/04/96	104.40	105.15	10.19 %	Apr. 19
GENERAL ELECTRIC 11 $\frac{1}{2}$ % 7/02/95	102.10	102.85	9.50 %	Feb. 07
SWISS FRANC DENOMINATED BONDS				
GOVT. OF AUSTRALIA 5% 30/10/98	100 $\frac{3}{4}$	102 $\frac{3}{4}$	4.41 %	Oct. 30
DANISH KRONE DENOMINATED BONDS				
KINGDOM OF DENMARK 9% 15/11/94	101.40	102.15	7.32 %	Nov. 15
ECU DENOMINATED BONDS				
UNITED KINGDOM 9 $\frac{1}{8}$ % 21/02/01	108.85	109.60	7.43 %	Feb. 21
BRITISH POUND DENOMINATED BONDS				
KGDM OF SWEDEN 8 $\frac{3}{4}$ % 29/5/96	103 $\frac{5}{8}$	104 $\frac{3}{8}$	7.07 %	May 29
FRENCH FRANC DENOMINATED BONDS				
CREDIT LYONNAISE 9 $\frac{1}{2}$ % 23/12/96	107.35	108.10	6.83 %	Dec. 23
JAPANESE YEN DENOMINATED BONDS				
WORLD BANK 5 $\frac{3}{4}$ % 7/8/96 RRSP eligible	104.90	105.65	3.82 %	Aug. 07
CANADIAN DOLLAR DENOMINATED BONDS				
ONTARIO HYDRO 10 $\frac{7}{8}$ % 08/01/96 (semi annual)	107 $\frac{3}{4}$	108 $\frac{1}{2}$	7.35 %	Jul. 08
EKSPORTFINANS 7 $\frac{3}{4}$ % 5/11/97	99 $\frac{3}{4}$	100 $\frac{1}{2}$	7.59 %	Nov. 05
ROYAL BANK OF CANADA 9 $\frac{1}{8}$ % 7/1/97	103 $\frac{1}{8}$	103 $\frac{7}{8}$	7.82 %	Jul. 07
SOUTH AFRICAN RAND DENOMINATED BONDS				
ESCOM 11% 31/10/93 (semi)	98.85	99.60	11.91 %	Oct. 30
AUSTRALIAN DOLLAR DENOMINATED BONDS				
COMMONWEALTH BANK OF AUSTRALIA 14% 01/07/94	107 $\frac{5}{8}$	108 $\frac{3}{8}$	5.72 %	Jul. 07
NEW ZEALAND DOLLAR DENOMINATED BONDS				
NEW ZEALAND GOV'T 10% 15/7/97 (semi)	110 $\frac{1}{2}$	111 $\frac{1}{4}$	6.82 %	Jul. 15
ARGENTINEAN PESO DENOMINATED BONDS				
ARGENTINA BIC V FIXED/FLOATING 1/05/2001 callable in full on every interest date	92.60	93.35	12.96 % IRR	4th day of mth.
U.S. DOLLAR DENOMINATED FIXED CONV. BONDS				
DATAPOINT CORP. 8 $\frac{7}{8}$ % 1/6/06 CV @ \$18.11 p/sh (semi)	77 $\frac{1}{2}$	78 $\frac{1}{2}$	12.59 %	Jun. 01
BURNUP & SIMS 12% 15/11/00 (semi) CV @ \$16.79 p/sh	87	89	14.98 %	Nov. 15
ATARI CORP. 5 $\frac{1}{4}$ % 29/4/02 CV @ \$16.31 p/sh	49	50	16.25 %	Apr. 29
COEUR D'ALENE 6% 10/6/02 CV @ \$26.00 p.sh	101 $\frac{1}{2}$	103	5.57 %	Jun. 10
U.S. DOLLAR DENOMINATED FIXED RATE BONDS				
FARM CREDIT CORP. 7 $\frac{3}{4}$ % 10/06/96 RRSP eligible	107 $\frac{3}{4}$	108 $\frac{1}{2}$	4.66 %	Jun. 10
U.S. DOLLAR DENOMINATED FLOATING RATE NOTES				
UNITED KINGDOM 24/09/96 3 mo. LIBID- $\frac{1}{8}$ (qtlly) *callable @ 100	99.80	100.10	3 $\frac{1}{16}$ %	Jun. 30

HOTLINE UPDATE

Tuesday, April 27:

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

Friday, April 30:

There are no changes or new recommendations.

*Please note that the telephone number for our Hotline Update will be changing as of Monday, May 3.

Tuesday, May 4:

There are no changes or new recommendations.

Fash Update, Wednesday, May 5, 10:58 a.m.:

Liquidate long Swiss franc positions at the market; June currently trading at .7027.

Friday, May 7:

This is a recap of recommendations for the week.

On Wednesday, May 5, via flash update, we liquidated the June Swiss franc at the market, then trading at .7027. There are no other changes or new recommendations.

Flash Update, Monday, May 10, 2:35 p.m.:

Re-enter the Swiss franc position; buy June Swiss franc at the market, currently trading at .6833.

Tuesday, May 11:

This is repeat of the flash update from Monday, May 10. Re-enter the Swiss franc position — buy June Swiss franc at the market, then trading at .6833. There are no other changes or new recommendations.

Friday, May 14:

This is a recap of recommendations for the week.

On Monday, May 10, we recommended to re-enter the Swiss franc position; we bought June Swiss franc at the market, then trading at .6833. There are no other changes or new recommendations.

Flash Update, Monday, May 17, 8:30 a.m.:

Liquidate long June Swiss franc positions at the market, currently trading at .6868.

Flash Update, Monday, May 17, 2:00 p.m.:

Liquidate all long precious metals positions at the market. June gold is presently trading at 368.00, July silver at 444.00,

July platinum at 387.00. And to repeat this morning's flash update at 8:30 a.m., liquidate long June Swiss franc positions at the market, then trading at .6868.

Tuesday, May 18:

This is a repeat of the flash updates from Monday, May 17. First, we liquidated long June Swiss franc positions at the market, then trading at .6868. Secondly, we liquidated all long precious metals positions at the market. There are no other changes or new recommendations.

Flash Update, Wednesday, May 19, 2:00 p.m.:

Liquidate Dec. S&P 400 strike put option at the market, currently trading at 5.60.

Friday, May 21:

This is a recap of recommendations for the week.

On Monday, May 17, via flash update, we liquidated long June Swiss franc positions at the market, then trading at .6868. Also, we liquidated all long precious metals positions at the market. June gold was then trading at 368.00, July silver at 444.00, and July platinum was trading at 387.00.

On Wednesday, May 19, via flash update, we liquidated Dec. S&P 400 strike put option at the market, then trading at 5.60. There are no other changes or new recommendations.

Flash Update, Monday, May 24, 8:30 a.m.:

Buy August gold at the market, currently trading at 382.00; place initial stop at 374.00, good anytime.

Tuesday, May 25:

There are no changes or new recommendations.

Friday, May 28:

This is a complete summary since our last market letter dated April 25 of all liquidations of open positions and new recommendations that remain outstanding.

On Wednesday, May 5, via flash update, we liquidated long June Swiss franc at .7027.

On Monday, May 17, via flash update, we liquidated all long precious metals positions; June gold at 368.00, July silver at 444.00, July platinum at 387.00.

On Wednesday, May 19, via flash update, we liquidated Dec S&P 400 strike put options at 5.60.

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