FRIEDBERG'S
COMMODITY & CURRENCY COMMENTS

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The second coming?

Those who predict a second coming for gold do so on faith. And in this respect they share their fervor with their religious counterparts.

Faith that governments cannot be relied upon to preserve purchasing power. Faith that in the long run, income-bearing government obligations will be as useless as the paper they are being printed on. Faith that gold cannot be repudiated, reneged upon, debased, or taxed away as may currencies and other financial assets.

In anything but the very long run, they are wrong. Western governments and their constituents have adapted rather admirably to fiat money over the past 200 years. While the first banknotes were redeemable into gold, it was not long before conversion was restricted.

By the middle of the twentieth century, gold-backing for money had all but disappeared. An unbacked paper standard ruled the world, and no one was known to have lost sleep over the fact that his/her wealth reposed in worthless pieces of paper, whose issuance was wholly at the discretion of free-spending governments.

The adaptation process did not come smoothly. As late as the '70s, the mere closing of the US gold window, and thus the end of the fixed rate Bretton Woods regime, caused shock and apprehension; international monetary discipline had been thrown overboard and — who knew? — paper money could have become worthless.

The nightmare lasted almost a decade. As governments learned to cope with the various Ms, rationality returned to the marketplace. Creeping inflation was to be tolerated, but no more than that. The threshold of political pain hung around the 5% inflation rate.

Financial markets adapted rather well to the steady, but fully expected, erosion in purchasing power. Only unanticipated, accelerating inflation would cast doubts on the paper repositories of our wealth. And, since by definition, this is not foreseeable, no case can be made for a monetary demand for gold.

Not only did simple citizens come to believe in fiat money but also even the staunchest of central banks. These solemn and conservative institutions began to "mobilize" their gold reserves. Never mind that they did not need international reserves to prop up their currencies — but weren't Eurodeposits more attractive than barren gold bars?

We had come full circle. Free financial markets would be able to price yields and returns of assets denominated in fiat money in such a way as to dispense with *monetary* gold. If inflation were to accelerate, and implausibly, if the rate of acceleration were foreseeable, yields and returns would reflect the new circumstances. Lacking an energetic central bank response, investors would withdraw from long maturities and concentrate in the short end of the bond and money markets driving long-term rates higher. Once again, returns would exceed purchasing power erosion, making gold purchases unnecessary.

The more plausible scenario — (simply because that is the nature of accelerating inflation) that inflation accelerated and its rate of acceleration was unanticipated — would again reawaken the fears of paper money debasement and bring alongside a monetary run on gold. But here we would have to assume that rational central banks (in varying degrees of independence) would not respond — an implausible assumption.

One may conclude, therefore, that the only scenario for a bubble in gold prices presupposes that most of the important central banks in the world wold relinquish their sacro-

In this issue

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

Important Note

Our July/August issue will be dated August 1, and will appear in the first week of August.

sanct duty to the maintenance of creeping inflation (1% to 5% per annum). If only a few did, their currencies would collapse *vis à vis* the currency of their tougher colleagues, and the ensuing political uproar would ensure compliance with the rest of the planet.

These conclusions are valid so long as financial markets are permitted to function freely and without controls. Then, and only then, can fiat money be superior to gold. On the other hand, should interest rates and/or foreign exchange controls be imposed in a particular country, its paper money would be rejected in favor of foreign exchange (via black markets) or gold. If for whatever reason, gold is preferred, a temporary bullish effect on bullion may take place. (Should *most* governments impose interest rates and/or foreign exchange central, a monetary demand for gold would surface. Which would lead us to a second scenario for a sustained gold bubble.)

The conditions, then, for a *sustained rise* in gold prices beyond present levels, *at this time*, are clearly absent. Neither inflation (in the OECD) is accelerating in an unexpected fashion nor do we find, in those countries, pervasive controls on financial markets. More likely, gold will continue to be demonetized, as returns in paper money continue to be more attractive.

Even on a purely price basis, (i.e., a non-monetary or commodity basis) gold is no bargain. Chart 1 depicts gold compared with US wholesale prices since 1913, the year prior to World War I. This year was chosen because it marked the high points of the International Gold Standard, which necessitated a high real gold price. In effect, $20.67/oz. was sufficiently high to permit central banks to hoard most of the world's gold and all of its new production. Even on this basis, gold should not trade much above $200/oz.

Chart 2 compares gold with US wages since the end of World War II. Despite the intervening inflation caused by the war, prices had barely begun to regain their pre-depression levels. At $35/oz. the US was still managing to increase its Fort Knox holdings, indicating that gold, *as a commodity,* was still too dear. While the comparison is a bit more favorable, here too gold *as a commodity* is shown to be no bargain.

What then is the reason for the recent jump in prices? Quite clearly, China.

In the midst of a formidable boom, Chinese inflation has begun to accelerate beyond control, stoking the demand for foreign exchange. As the yuan fell, earlier this year, below 8 yuan to the dollar in the swap centre markets (a 40% depreciation from the official rate of 5.71 yuan), offers for dollars disappeared as a ceiling was imposed. Some demand for dollars was rerouted to the black market, where they traded at over 10 yuan.

More typically, Chinese citizens concerned with the daily loss of purchasing power and unable to invest in money market instruments with real yields turned to buying consumer goods and gold jewellery. Since controls on the swap centres were lifted on June 1, the yuan has stabilized in the 10.67 to 11.00 area, although black market transactions are reportedly being done at 14-15 yuan to the dollar.

Only 8.3 billion yuan out of a recent government bond issue of 30 billion yuan (which represents only one third of China's 1992 budget deficit) was placed by the end of May, as interest rates offered on the bonds were extremely unattractive. Despite the new and higher rates, 12.52% on a three-year bond and 15.06% on a five-year bond, investors are reluctant to buy them in view of 20%-plus inflation rates.

These controls on financial markets are likely to maintain Chinese interest in gold: Last year they consumed 250 tonnes, while this year, their purchases may exceed 350 tonnes (17% to 18% of world output).

Can the impact on world prices be sustained? We do not think so for three good reasons:

a) Provided swap centers and black markets operate, money supply *in dollar terms* will begin to shrink and with it, purchasing power (note in Chart 3 the effect on the real level of domestic credit of the early fall to 8.00 yuan);
b) The government is quite concerned about inflation and is likely to squeeze further the growth of credit to state enterprises, raise interest rates sharply (making paper money more attractive), and reunify the exchange rate market (removing some pressure from the freely floating rates);
c) If the present mini-bull market is well understood (i.e., as not being the product of a worldwide demand for monetary gold), the process of demonetization will accelerate: Central banks and rational investors will sell into rising prices.

How high can prices rise? This is an extremely difficult question and one that we are prepared to answer in a very positive way. Gold loans and the proliferation of a myriad of derivative products have built massive short positions that are likely to trigger huge protective buy stops somewhere between $375 and $425/oz. Delta hedging and other dynamic techniques exaggerate market movements, because they are destabilizing in nature, i.e., buy on rising prices and sell on declining prices. In 1987 they turned a stock market correction into a crash; in 1993 they could turn this mild 15% to 18% rise into an *explosion.*

To appreciate the magnitude of the potential for destabilization, one should note that at the end of last year, the total amount of gold associated with outstanding *producer* derivatives was estimated at 1,215 tonnes, up from 1130 tonnes in 1991, more than 50% of one year's output. At the same time, exchange-traded options outstanding remain high: There are over *66,500* calls open in the overhead 380-400 range with expirations from early July to early November, which together with a commitment of 174,110 futures contracts, represent *potential* sources of buying equal to 7.4 trading days.

In conclusion, gold is in the midst of a bull move that is likely to be temporary but very dramatic, aggravated by the recent proliferation of hedging techniques and derivatives. A sort of crash-in-reverse.

STRATEGY: *You are long, once again, as per flash update of Friday, June 25 at approximately $378.30, basis December '93. Place stops at $364, good anytime.*

Chart 1

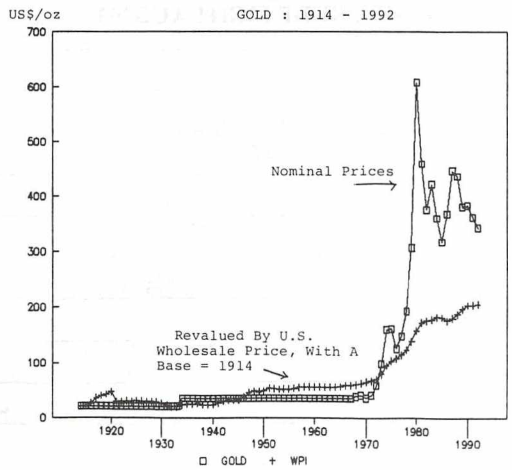


Chart 2

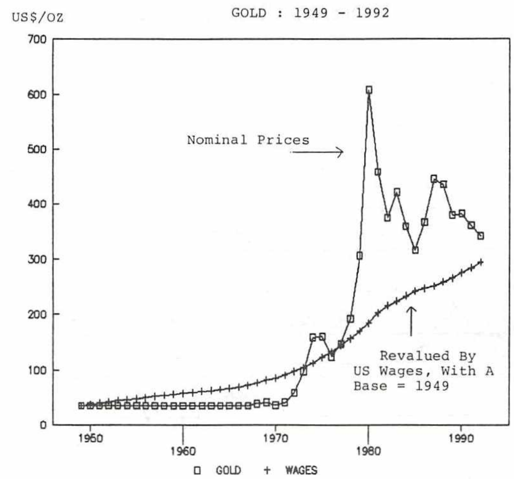


Chart 3

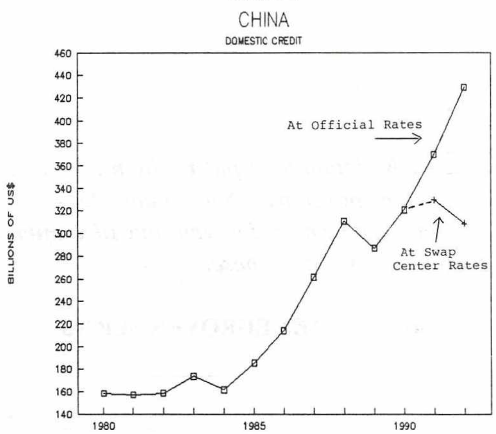
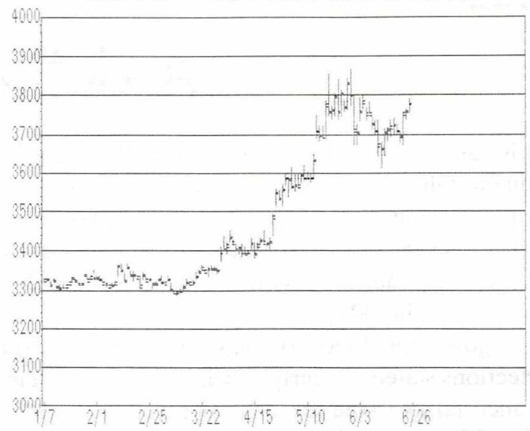


Chart 3A – COMEX GOLD AUG '93



OIL

Into single-digit numbers?

An unusual event has occurred over the past seven weeks: Crude prices have moved to substantial contango, with a six-month forward position now trading as much as 90¢ per barrel above the nearest month. Clearly, OPEC supply, now running around 24.5 million barrels per day, is excessive in view of weak European and Japanese demand.

In our opinion the refusal of Kuwait to sign the latest OPEC accord and its decision to increase output above 2 million barrels per day by October from 1.6 million barrels per day at the end of the last accord has more to do with rational long-term economic thinking than with reconstruction needs.

The opening up of the Caspian Sea to oil exploration by multinational companies is sure to have major repercussions among Gulf producers. While oil is unlikely to flow out of these former Soviet Republic provinces in the near future, the threat five to seven years out is formidable.

Oil in the ground is and will continue to be a depreciating asset; the present value of oil to be produced in the year 2000 may be little more than $1-$3/barrel. This should prompt Gulf producers to seek to maximize present production, then lower prices to the $8-$12 range to discourage future exploration and development and to encourage more rapid consumption.

Also to be factored in is the inevitability of the resumption of Iraqi oil shipments, which will add 3-4 million barrels per day to an already glutted market.

Futures trading per force requires a delicate sense of timing. There are times, however (such as now), where timing is not as crucial. That's because forward positions are at a premium, and we are being paid to remain short. At the same time, option premiums are showing the lowest implied volatilities in recent years as the market has been lulled into an incredible complacency: The big bears think of $17/barrel, while the big bulls are satisfied with $21/barrel.

Years of range trading have lowered the professionals' guard. Now is the time to strike. We are super bears and think about single digit numbers.

STRATEGY: *We are urging you to add to outstanding short positions and to long put options.*

Chart 4
NYME CRUDE LIGHT

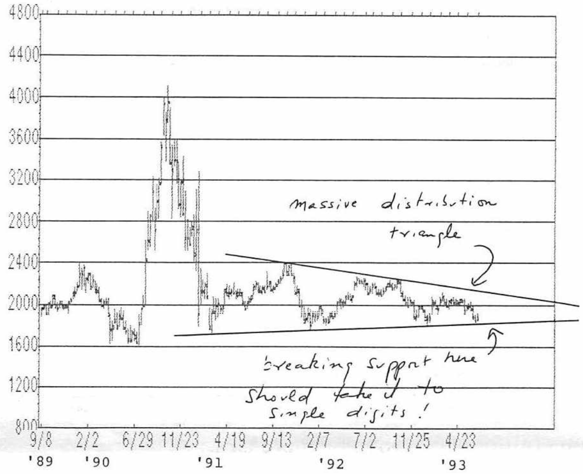
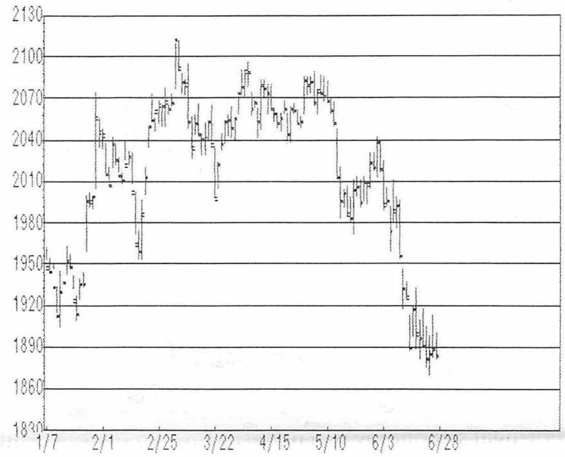


Chart 4A
NYME CRUDE LIGHT AUG '93



JAPAN

A deflationary vortex

Japan is caught in a deflationary vortex. Real estate prices continue to fall more than three years after their peak, consumer prices remain practically unchanged, wholesale prices are down 3% year over year, and the yen continues to rise despite the fact that the country is experiencing the worst recession since the '30s.

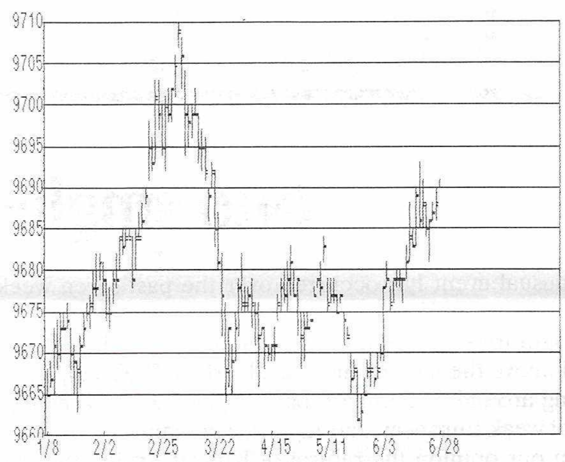
The government's loss of the vote of confidence and the new elections slated for early July are adding an element of fiscal uncertainty to the recently approved package of fiscal stimulus. Much better would have been a plain across-the-board tax cut, and perhaps that will come after all once political reform is underway. But for now, the recession reigns supreme.

Against this background of fiscal inaction, the Bank of Japan will have to reconsider its decision not to lower interest rates, although it may want to wait until the little bit of optimism that was generated when the Nikkei rose above 21,000 is squeezed out.

We still believe that the Nikkei is heading to new lows and the Euro-yen deposits to new highs.

STRATEGY: *Maintain long put position in Amex equity options. Add to long positions in September/December Euro-yen deposit contracts. The rising yen and BOJ intervention virtually guarantee a profit on these.*

Chart 5 – SIMEX EUROYEN SEP '93



S&P

Stay long, stay alert!

Sentiment indicators, a firm bond market, the prospective collapse of oil prices (in our opinion), and improved breadth despite a severe mauling of selected sectors, augur well for the near term. Nevertheless, the absurd valuation levels should prompt us to exercise restraint.

STRATEGY: *Remain long as per flash update of Tuesday, June 22. But be sure to leave protective stops at 442, good anytime. Over the next few days we will be raising this stop.*

PORTUGUESE ESCUDO

A carry trade

Instead of celebrating the much-advertised launch of "EC-92," the European Community is worrying about an increasingly severe slump. In addition to a short-term business cycle slump, the EC appears to be finally buckling under the weight of a heavy welfare state and completely rigid labor markets. Indeed, that combination has been deadly over the long-term: Since 1965, the EC generated only 13 million new jobs, less than half the growth of the working population of 33 million.

When reviewing the EC ruin, we do find one relative bright spot: little Portugal. Although its economy has taken a dip along with all the other members of the EC, it appears that Portugal's economy will make it through the Euro-slump without recording an annual negative GDP. For a closer look at Portugal's relative strength in the European context, we rely on the OECD's newly released (June '93) *Economic Surveys — Portugal.*

Domestic demand in Portugal has remained persistently strong — when compared with the OECD average, it has been about 2.5 percentage points higher — because of continued growth in private consumption and renewed strength in foreign direct investment inflows and EC funds, which have supported investment in construction (see Chart 6).

We must mention that the strong flow of funds from overseas, which has fueled domestic demand, has been motivated by Portugal's accession to the EC (1986) and the escudo's entry into the Exchange Rate Mechanism (ERM) of the European Monetary System in April 1992. In addition to EC "funds," Portugal's accession to the EC forced that country to pursue a number of structural reforms. These have been successful and have improved the economy's performance.

Of particular note is Portugal's labor market flexibility, which is one of the country's greatest assets and something that sets it apart from other European countries. After the 1974 revolution, unemployment in Portugal increased to OECD levels. However, after Portugal entered the EC in 1986, it halved its unemployment rate, and by 1992 the unemployment rate was 4.5% (see Chart 6), or about 5.5 percentage points below the EC average. Moreover, the unemployment duration has fallen since the early 1980s.

Relatively low wages, the impact on growth of EC accession, and successive steps to liberalize the heavily regulated economy were instrumental in reducing unemployment quickly after 1986.

However, favorable unemployment developments are largely due to flexible wages. For example, wage equations for Portugal indicate that an increase of 1% in the rate of unemployment induces a reduction in real wages of between 1% and 1.4% in the long run. This represents a much higher response (flexibility) than in other European labor markets.

Meagre unemployment compensation and strict entitlement criteria provide a strong disincentive for workers to become and stay unemployed. Indeed, workers would rather have a job with lower real wages during lax labor market conditions than no job and low unemployment benefits, a result that would occur if workers failed to agree to lower real wages.

In reviewing the economic fundamentals, inflation remains the only stubborn problem (see Chart 6). Indeed, Greece is the only country in the EC with higher inflation, but Greece is not in the ERM.

Given its relatively high inflation, Portugal must have relatively high nominal interest rates, and it does: Portugal's three-month Euro-rates (13.5%) are the highest in the ERM, about 555 basis points above the Dutch rates (which are the lowest) and 480 basis points above the German rates. As a result of those high rates within the context of the pegged ERM system, Portugal attracts foreign capital, particularly when confidence in the peg increases.

These capital flows put the escudo at the top of the ERM grid. Moreover, they create instability within the pegged exchange rate system. As Sir Alan Walters has repeatedly pointed out, the capital inflows to the high inflation rate, high interest rate country (such as Portugal) tend to increase, not diminish, monetary growth and so will exacerbate, rather than reduce, inflation. Ultimately, the perversities of the pegged system give way to speculation instabilities, which we have witnessed in the ERM since September 1992.

STRATEGY: *During periods when the ERM is calm, so-called carry trades can be attractive if interest rate differentials between pegged currencies in the system are large. In that case, speculators can pocket the interest rate differential by going long a high interest rate currency and short a low interest rate currency.*

We believe the Europeans have temporarily avoided another ERM crisis and are retreating for calm summer holidays. Hence, the ERM will be stable until fall, when people return from holidays and realize that the Euro-slump is worse than it was in June. During this period of calm, large yield pickups (about 555 basis points) can be had by long escudo/short Dutch guilder trades.

For those who want to avoid the risk that all speculators aren't on holiday and that they might once again test the Spanish peseta (which might spill over into the escudo), the most riskless carry trade is a long escudo/short Spanish peseta trade for a yield pickup of about 135 basis points.

– Dr. Steve H. Hanke

Chart 6
Economic Indicators (% Changes)

	1992	1993	1994
Total Domstic Demand (real)	4.1%	2.9%	3.0%
GDP (real)[1]	1.4	0.9	1.7
CPI	9.5	7.5	6.0
GDP Deflator	12.8	8.5	6.3
Unemployment Rate	4.5	5.1	5.7
Current Account Balance[2]	-0.0	-0.5	-0.25

[1]GDP is less than total domestic demand because of negative balance of trade.
[2]As a % of GDP.
Source: OECD, June 1993.

COMMODITIES

As my auntie Polly would say — and, over the years, she's said it better than anyone else I've heard — *feeeh!* Commodity markets have been about as inspired and inspiring as reconstituted chicken soup. The CRB (Commodity Research Bureau) Index has mired itself in a trading range of between 202.00 and 208 (basis cash) and has been utterly unresponsive to the primed-up money supply (see our past three issues).

Has the embryonic bull market miscarried? We doubt it, though an ultrasound would certainly be welcome.

Cocoa

During the month, prices fell to within $45 per tonne of lows approached in 1991, then bounced nicely. The bounce is a strong signal those lows are unlikely to be broached. In other words, cocoa at around $800 per tonne (basis the cash, or nearest futures, price) is probably as cheap as cocoa is going to be.

Unfortunately, there is not much more positive opinion we can report. As we discussed at some length last month, this year's deficit is too small to make a significant dent in burdensome stocks, which we calculated at better than six months' supply. In fact, we estimate we would have to have deficits for the next three or even four years before inventories were worked off to levels that approached those of the 1970s (the period during which the last bull market in cocoa occurred).

The erosion of inventories to bull-market levels will occur. A recent study conducted by the FAO (The Food and Agriculture Organization of the UN) predicted cocoa output will decline to a growth rate averaging 1.8% annually over the next six years. This compares with a growth rate that has averaged 4.3% annually since 1980 and a rate of consumption increases that we forecast last year would average 4%. Unfortunately the statistical picture will be painted to the satisfaction of only those patient few who are willing to pay and lose the contango (the premium of futures prices to cash prices) in the hope of being right there on the ground floor when it happens.

We are not among them.

Ivory Coast main crop beans will not be offered to market until mid-September at the earliest. Between now and then we would expect a rally to liquidate our long-held long positions into. Stay posted via the hotline and retain stops at 800 basis cash.

Corn

Last year we had a wet spring and early summer. Traders feared, first, that the crop would be late planted and therefore vulnerable to frost at harvest time; later, that the rain would leave the crop vulnerable to extreme heat during the critical pollination stage that occurs the first few weeks in July. The result? The corn crop was bountiful.

This year the weather is not dissimilar to last year. About a million fewer acres of corn were planted this year than last year, but yields are expected higher so that, overall, production is predicted 17% higher than last year's 9,016 mln bushel crop. The current price is about 10% less than it was at this time last year.

During the next two weeks the market will perform its annual rite of scrutinizing pollination. A "pollination" premium would be a sexy opportunity to sell. Subscribers, stay posted via our hotline and raise stops to 210 basis July.

Sugar

Prices have defied the bullish statistical picture that we described last month at some length and fallen to beneath risk-defining zones. As per last month's *Comments*, we have been stopped out.

We understand the market has fallen because of what we ought properly to consider a technical factor. The #6 sugar contract ceased trading on the London Terminal, and Brazilian crystalline sugar, which typically used to be delivered there, was offered in London against short positions in delivery on the New York Coffee and Sugar Exchange (CCS).

The Brazilian crystalline sugar is a lower quality sugar. Many traders assumed the governors of the CCS would rule the Brazilian sugar unacceptable for delivery against the New York contract. When the governors ruled they would accept the Brazilian sugar, the market's response seems to have been an overly emotional one. Nervous longs imagined surplus supplies coming to market and bailed out. Open interest fell from 123,000 to 98,000 contracts.

Sugar statistics are too bullish to ignore. A deficit of 4.0 mln tonnes is expected. Sceptics may argue the deficit comes about solely as a result of poor weather in India, Thailand, South Africa, and Cuba and is therefore only temporary and sure to be alleviated next (sugar) year.

There are two problems with this argument. The first is that the decline in Cuban sugar production has much more to do with the beleaguered island nation's inability to finance fertilizer and transportation than it has with hurricanes. The second is that if the sceptics are wrong and next year's sugar production is adversely affected, prices could go to 50¢ a pound. The insurance users must assume to protect themselves against such a circumstance should serve as a cushion against declines from current levels.

We advise being long again, this time the October contract, with stops at 9.90.

– David B. Rothberg

FOREX

The Australian dollar

Since September 1991, the value of the Australian dollar has depreciated by about 13% in trade-weighted index terms. During the same period, commodities, which represent around two thirds of Australia's total export earnings have dropped by approximately the same amount.

At present the Australian dollar is within 3% of its low against the basket of currencies.

STRATEGY: *As commodity prices have not yet gone up significantly, we would buy the Australian dollar only if it dropped to around US63¢ and sell only if the currency rallied to US71.50¢. Presently, the Australian dollar is US66.80¢.*

FRIEDBERG CAPITAL MARKETS

Transworld Airlines, Inc.

17.25% Senior Notes & 16% Senior Notes
Status: Defaulted and being re-organized
Recent price: $29
Proposal: Each $1,000 note exchangeable into 1) $471 face value of 7-year 8% notes; 2) 17 new preferred shares; 3) 10 new common shares.

Background

Trans World Airlines, Inc. (TWA) is one of the major US-based airlines engaged in the transportation of people, property, and mail. Its geographic coverage includes most of the US and part of Western Europe (e.g., Brussels, Frankfurt, London, and Paris). Owing to the prolonged economic recession and extremely keen competition in the airline industry, TWA ran into serious financial problems in 1991. Finally, it filed a voluntary Chapter 11 case in the Bankruptcy Court on January 31, 1992 to undergo a re-organization.

After nearly 18 months of negotiations and planning, TWA has reached agreements with various labor unions and most creditor constituencies regarding its reorganization plan (the "Plan"). A disclosure statement has been issued and a voting deadline set on July 8, 1993.

The reorganization plan

The major objectives of the Plan are to reduce the amount of TWA's debt and to maximize the value of ultimate recoveries to all creditor groups on an equitable basis, while allowing TWA to continue as a going concern. TWA's total debt at the end of 1992 was approximately $3 billion, with $2 billion subject to compromise in the Chapter 11 reorganization. Of this $2 billion, public debt securities account for $1 billion, and they consist of senior secured notes, senior unsecured notes, and junior subordinated debentures.

The debt securities we recommend are TWA's 17.25% and 16% senior unsecured notes (the "Notes"), which have $334 million outstanding and are classified as "Class 8 - Senior Unsecured Claims."

The estimated claim amount in Class 8 is approximately $534 million. Other than the Notes, the major claims in this class arise from the rejection of unexpired capitalized aircraft leases, estimated at $119 million.

TWA proposed that each holder of an Allowed Claim in this class receive a pro rata share of i) $251,556,000 in principal amount of new seven year notes, ii) 9,135,000 shares of new preferred stock, and iii) Voting Trust Certificates (VTCs) evidencing the beneficial ownership of 5.5 million shares of reorganized TWA's new common stock.

Therefore, based on the estimated claim amount, each $1,000 face value of the Notes will be entitled to i) $471 principal amount of new seven year notes, ii) 17 shares of new preferred stock, and iii) VTCs evidencing the ownership of 10 shares of new common stock. According to TWA's valuation, this settlement will allow Class 8 creditors to recover 32% of their claims. The details of these new securities will be discussed later.

The 15% senior secured notes are classified as "Class 7 - Senior secured claims." Under the Plan, creditors in this class will receive a portion of their claims in cash and a portion in new five year notes. The estimated recovery rate is 85%. Furthermore, the subordinated debentures are classified as "Class 9 - Subordinated Unsecured Claims," and each $1,000 bond will be entitled to 26 shares of new common stock.

We believe the Notes are the most attractive among TWA's three types of public debt securities. The senior secured notes, recently trading at $101, will provide too low a return compared with the risks, while the subordinated debentures, although recently trading at only $4.50, will be too risky, because the return depends totally on the common stock's value.

Under the Plan, no assets will be left to be allocated to existing preferred and common share holders. Shares of new preferred stock and new common stock will be issued to creditors and employees as part of the settlement. The Plan proposed that a total of 12.5 million shares of new preferred stock and 20 million shares of new common stock be issued.

Other important aspects of the Plan include the agreements TWA has reached with its labor unions and the settlement of its pension fund liabilities. It has obtained concessions from various unions equivalent to a 15% reduction in wages and benefits for three years and the forgiveness of certain claims by TWA's employees.

In return, TWA will issue 45% of the new common stock to trusts established for the benefit of TWA's unionized and nonunion employees. In addition, TWA agreed to issue three Pension Plan Notes of $300 million in total to the PBGC (Pension Benefits Guarantee Corporation) in full settlement of the alleged $1.124 billion of unfunded pension liability. The current pension plans will be terminated upon the Plan's confirmation. New pension plans will be set up, and Pichin Corp., a company controlled by Mr. Carl Icahn (former CEO of TWA), will be the contributing sponsor and administrator of the new plans.

Terms of new securities

The proposed new securities will be issued on the Effective Date, which is a business day at least 11 days after the Confirmation Date. Since the deadline for voting is July 8, the Plan should be confirmed in mid July if the voting is favorable. In this case, TWA expects to issue the new securities around August 1, 1993.

New seven-year notes: The seven-year notes will carry a coupon rate of 8% per annum and mature on February 1, 2000. Interest will be paid semi-annually. However, for the purpose of conserving cash, interest will be paid in kind (in the same seven-year notes) until the end of the unions' concession period (September 1, 1995). Interest will be paid in cash thereafter. The seven-year notes are secured by TWA's international routes and the stock of certain TWA's affiliates. However, the lien on the international routes are subordinated to that granted to secure the Pension Plan Notes.

New preferred stock: A total of 12.5 million new preferred shares will be issued to holders of Allowed Claims in Classes 8 and 10. The new preferred shares will not be entitled to any dividends until June 1, 1995. Thereafter, they will be entitled to cumulative annual dividends at 12% of the liquidation preference value. The liquidation preference value after June 1, 1995, is set at $12.40 per share. In other words, each preferred share is entitled to an annual dividend of $1.49.

New common stock: A total of 20 million of new common stock will be issued to the New Voting Trust and the New Employee Common Stock Trust. The holders of new common stock will be entitled to one vote for each share held and to any dividends declared by the re-organized TWA board of directors. However, we do not expect TWA to pay any dividends on its new common stock in the foreseeable future.

Valuation of securities

If the Plan is duly confirmed, holders of the Notes will be issued a package of new securities of the re-organized TWA. Therefore, to evaluate whether these debt securities are a good buy now, we must estimate the value of the new seven-year notes, new preferred stock and new common stock.

Since the securities are highly speculative, we believe the valuation should be based on conservative assumptions. Our methodology is to assess the value of the securities package without the new common stock, and treat it as a free upside opportunity. We believe it is a sensible method because both the seven-year notes and new preferred shares will be entitled to cash income in the future, whereas the value of the new common stock is totally determined by the market's assessment of TWA's growth potential.

There are additional assumptions in our valuation models. First, the new preferred shares will be sold as soon as possible (assuming at the end of August 1993). Sale of the preferred shares will generate immediate cash income (which should be the objective of most bond investors) and reduce risk to the investors. Second, the pay-in-kind (PIK) interest on the seven-year notes also will be liquidated immediately upon receipt. In addition to generating cash income and reducing risk, our analysis indicates that keeping the PIK interest will increase return by only about 50 basis points. We do not believe the increased return is worth the risks.

Based on the above assumptions, we estimated the yield of the Notes under different scenarios. The most "optimistic" scenario assumes the preferred shares will be priced using a 25% discount rate ($3.70 per share) and the PIK sold at a 25% discount. The least "optimistic" scenario assumes the preferred shares will be priced using a 40% discount rate ($1.80 per share) and the PIK sold at a 50% discount. We believe the ranges of the discount rate and discount are reasonable based on our assessment of the risks and liquidity of these securities. In summary, the estimated annual yield under the most "optimistic" scenario is 21.4% and it is 17.8% under the least "optimistic" scenario.

Now let's look at the free upside opportunity — the new common stock. Since the dividend discount model of stock valuation does not apply here (no dividends expected on the common stock), we used the before-debt market capitalization (BDMC) to earnings and before-debt market capitalization to sales.

The BDMC measures a company's market value if it were debt free. It is computed by adding the amount of total debt to the market value of both preferred and common shares. For highly-leveraged airline companies, it more accurately measures the value of the fundamental business. We calculated the BDMC to 1994 expected earnings for five public airline companies (Delta, Alaska, USAir, United, and American).

The average multiple is 23. However, we believe TWA is most similar to USAir in its size and scope of operations (both serve trans-continental and trans-Atlantic routes). Therefore, we applied the multiple of USAir (19) to TWA's 1994 expected earnings ($141 million) to derive the BDMC.

Unfortunately, the BDMC in this case can only cover all the debt ($2.7 billion), which means the common stock will be worth nothing.

However, the BDMC to sales method produced a different result. A calculation of the same five airlines' BDMC to sales (1992 sales) gave us an average multiple of 0.97. Again, we applied the multiple of USAir, which is 0.87, to TWA's 1992 sales. After deducting total debt and preferred equity (valued at $3.7 per share), the common equity is worth an estimated $426 million, equivalent to $21 per share.

In conclusion, the new common stock can be worth anywhere from zero to $21 per share. TWA assigned a book value of $2.50 per share, and our research indicated that the common stocks of all the five public airlines were trading at above their book values, despite continued losses. The multiple ranged from 2.2 to 23.2. Therefore, a more probable range of the common stock price will be between $2.50 and $21 per share. At $2.50 per share, the estimated yield on the Notes will be 24% in the most "optimistic" scenario, whereas at $21 per share, the estimated yield can be as high as 78%!

Prospects of TWA

The above analyses and computations assume that TWA will successfully turn around and improve its financial position so that it will make all scheduled interest and dividend payments. This is a big assumption, undoubtedly. Nevertheless, based on both industry-specific and company-specific factors, we believe TWA has a good chance of resuming profitability after the restructuring.

The macroeconomic environment is the most important industry-specific factor. The economic recovery in the US is expected to speed up, which will increase the number of both business and leisure travellers. In addition, the European economies, which are important markets of TWA, will eventually rebound in one to two years.

The upturning economic cycle will certainly benefit airline companies, which have high fixed costs. Second, we believe that the price of oil, which is a significant cost component to all airlines (15% of operating costs to TWA), will decline substantially in the next 12 months (see our comments under "Oil" elsewhere in this issue). It will boost the profitability of all airlines, including TWA.

Furthermore, the company-specific factors also are very favorable. TWA will come out of the restructuring as a lean and mean airline. Annual labor costs will be reduced by more than $300 million and interest costs by $200 million. By reducing its fleet size, it can save $100 million in annual aircraft lease costs. More important, the reorganized TWA will be 45% owned by its employees, which will eliminate most of the union problems facing other airlines and serve as a strong incentive for the employees to make the company competitive again.

Risks

We want to emphasize again that TWA's senior unsecured notes are highly speculative securities. There are various risks involved that can reduce the yield. First, the number of new securities to be distributed to the Noteholders is based on the amount of estimated claims in Class 8. There are disputed claims that may be subsequently allowed and classified by the Bankruptcy Court as Class 8 claims, and if that is the case, the interest of the Noteholders will be diluted.

Currently it is impossible to estimate the degree of dilution. In addition, the new securities may be distributed only on an incremental basis, until the issue of disputed claims has been settled. In this case, the cash flows to the Noteholders will be delayed, thus reducing yield.

Second, Class 8 creditors as a whole may reject the Plan and therefore force TWA to seek confirmation of the Plan using the Bankruptcy Code's "cramdown" provisions. Under the "cramdown" arrangement, allowed claims in Class 8 will be treated as Class 10 and for each $1,000 face value of the Notes, will be distributed $424 principal value of the new seven-year notes and 17 new preferred shares.

The recovery rate based on the estimated claims will decline to 26% from 32%. Since it will be worse off for the creditors, we believe Class 8 creditors, if they act rationally, will not reject the Plan.

Third, the value of the new securities depends totally on TWA's ability to make scheduled interest and dividend payments. In other words, if the expected economic recovery does not materialize or TWA fails to resume competitiveness, it will run into financial problems again, and the new securities will face high default risks.

Last but not least, the new securities will have high liquidity risks. There is no existing market for the new securities and investors may have to make substantial price concessions if they want to liquidate quickly.

STRATEGY: *The TWA's senior unsecured notes are high risk securities, but the expected return is also very high. Our yield analysis has incorporated some of the risk factors, and is based on the belief that TWA will be able to turn around. We believe that the Notes, at a recent price of $29, are an attractive buy for investors with extremely high risk tolerance and low liquidity needs. Hence, Friedberg Capital Markets will be making a continuous market in these securities.*

– Edison Lee

Update on Atari Corp.

Current Yield: 15.45%
Maturity: April 29, 2002
Recent stock price: $2.30 per share
Conversion price: $16.30 per share

Atari Corporation (Atari) has gone through a very difficult time in the past three years. Rapid technological changes and aggressive price cutting in the personal computer and video game industry have substantially hurt the company's profitability. Owing to its outdated computer products and a fiercely competitive video game market, Atari's sales have declined four years in a row, from $423 million in 1989 to $127 million in 1992.

Last year's net loss was $73.6 million, which was a result of eroding profit margins, inventory writedowns and restructuring charges.

Despite its poor past performance, we believe Atari is close to a turnaround. With shrinking market shares and sales, it has aggressively reduced costs, inventories, receivables and short-term debt. Its quick ratio (excluding inventories) has risen steadily from 1.0 in 1989 to 2.7 in the first quarter of 1993.

Holdings of cash and marketable securities totalled $44 million at the end of March 1993. Based on projected annual fixed charges of approximately $6.7 million for the next five years, Atari has no immediate liquidity problems.

More important, its R&D efforts have started to bear fruit. Having phased out the ST series of personal computers, it introduced the Falcon030 series last September and started small shipments in the first quarter of this year.

The Falcon030 is specifically designed for personal integrated media functions. It can record and play back sound that is better than CD quality and can be hooked up to various audio/visual equipment. Also Atari has obtained a license from Kodak so that the Falcon030 can play back, manipulate, and edit Photo-CD. Priced at $799 for the basic configuration, Falcon030 differentiates itself by targetting at the rapidly growing multi-media segment of the personal computer market. Its versatile features and affordable prices should enable Atari to establish a strong position in this market niche.

Another new product of Atari is Jaguar, which according to Atari is a revolutionary multi-media video game system. To be nationally introduced in a year, the Jaguar uses a 64-bit system, features 24-bit color graphics, produces 3-D polygons that can be manipulated in real time, and has a CD peripheral that can play CD, Karaoke, and Kodak's Photo-CD. If it is successfully introduced, it should improve Atari's sales and bottom line substantially.

Despite the new products' strong potential, we projected that Atari would not resume profitability until 1995. The main reason is that the Falcon030, just recently introduced, will not start generating profits until at least the last quarter of 1993. On the other hand, if the Jaguar is introduced nationally in 1994, the heavy marketing and promotion costs will more than absorb the profits of the Falcon030.

Other than the projected fixed charges, the major use of cash will be the marketing expenses and working capital requirements associated with the two new products. Atari has indicated that it intends to raise funds after the Jaguar is introduced to meet its working capital needs. We believe Atari will be able to obtain new financing at a reasonable cost, based on its debt-to-equity ratio of 1.6 and the new products' potential. If it issues an additional $15 million debt, its debt-to-equity ratio will rise to 3.2, and then decline gradually. Even at 3.2, the ratio is not considered dangerous for debt issuers in this yield category.

Atari's total debt to market capitalization ratio is currently 0.45, which is very favorable considering its weak financial performance. Although its stock price has more than doubled in the past two months, it is still far away from the conversion price. Therefore, at the recent price of $52.50, the conversion option is practically free.

We believe that the bonds, at a yield of 15%, are an attractive buy for aggressive investors.

– Edison Lee

Chart 7

Recommended bond portfolio allocation

For new portfolios, we recommend the following investments*:

1. US$ high-yield straight and convertible bonds	27%		4. New Zealand $ bonds	16%
2. Italia lira fixed rate	25%		5. Finnish markka fixed-rate bonds	10%
3. Argentina BOCON/BIC V	22%			

*The above allocation is listed in order of preference. Existing portfolios should redeploy continuing cash flows accordingly.

Chart 8
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 June 25, 1993.**

	U.S. $	NEW ZEALAND	AUSTRALIAN $	DEUTSCHEMARK	SWISS FRANC	JAPANESE YEN	DANISH KRONE	BRITISH POUND	FRENCH FRANC	EUROPEAN CURRENCY UNIT	CANADIAN DOLLAR	SOUTH AFRICAN RAND**	ITALIAN LIRA	ARGENTINEAN PESO	FINNISH MARKKA
1 year	3.51%		C.B.A. '94 yields 5.56% (0.6567 A$/US)				Denmark '94 yields 6.74% (6.7220 Dkr/US)					ESCOM '93 yields 12.36% (0.1964 US/SAR)			
2 year	4.14%												G.E. '95 yields 8.64% (1.6705 ITL/US)		Finland '95 yields 7.01% (6.0379 FIM/US)
3 year	4.45%			Bk of NS '96 yields 6.47% (1.8001 US/DM)				Sweden '96 yields 6.85% (1.3811 BP/US)	Credit Lyon '96 yields 6.32% (6.0392 Ffr/US)		Ont. Hyd '96 yields 6.78% (1.3708 US/Cdn)		NIB '96 yields 9.34% (1.7609 ITL/US)		
4 year	4.79%	New Zealand '97 yields 7.02% (0.4941 NZ/US)		World Bk. '97 yields 5.83% (1.7680 US/DM)		World Bk. '96 yields 3.63% (101.72 US/JY)					RBC '97 yields 7.51% (1.4215 US/Cdn)				
5 year	5.16%				Australia '98, yields 4.29% (1.4476 US/SF)										
7 year	5.50%			World Bk '00 yields 6.66% (1.8347 US/DM)						U.K. '01 yields 7.06% (0.9617 ECU/US)					
8 year	5.62%													BIC V '01 yields 13.06% (1.7227 US/ARG)	
Spot Exchange Rate	–	.5375	.6697	1.6995	1.509	106.35	6.5186	1.4785	5.726	1.1523	1.2830	.2132	1.535	.9993	5.7183

*For example, since a US$-based investor would receive 450 basis points (864-414) by holding the G.E. '95 ITL bond, the ITL/US can depreciate to 1.6705 ITL/US from the present spot exchange rate of 1.535 ITL/US over the next 2 years for the ITL investment to break even with current US$ 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 9
FOREIGN CURRENCY BONDS

Date: June 24, 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 5⅝% 07/05/96 RRSP eligible	97	97.85	6.47 %	May 07
WORLD BANK 5⅞% 4/02/97 RRSP eligible	99 ¼	100.10	5.83 %	Feb. 04
WORLD BANK 9% 13/11/00 RRSP eligible	112.35	113.20	6.66 %	Nov. 13
FINNISH MARKKA DENOMINATED BONDS				
REP. OF FINLAND 11% 15/6/95	106.20	107.05	7.01 %	Jun. 15
ITALIAN LIRA DENOMINATED BONDS				
NORDIC INV. BANK 12⅜% 19/04/96	106 ¼	107.10	9.34 %	Apr. 19
GENERAL ELECTRIC 11½% 7/02/95	103.15	104	8.64 %	Feb. 07
SWISS FRANC DENOMINATED BONDS				
GOVT. OF AUSTRALIA 5% 30/10/98	101.30	103.30	4.29 %	Oct. 30
DANISH KRONE DENOMINATED BONDS				
KINGDOM OF DENMARK 9% 15/11/94	101.95	102.80	6.74 %	Nov. 15
ECU DENOMINATED BONDS				
UNITED KINGDOM 9⅛% 21/02/01	110.95	111.80	7.06 %	Feb. 21
BRITISH POUND DENOMINATED BONDS				
KGDM OF SWEDEN 8¾% 29/5/96	104	104.85	6.85 %	May 29
FRENCH FRANC DENOMINATED BONDS				
CREDIT LYONNAISE 9½% 23/12/96	108 3/4	109.60	6.32 %	Dec. 23
JAPANESE YEN DENOMINATED BONDS				
WORLD BANK 5¾% 7/8/96 RRSP eligible	105 ¼	106.10	3.63 %	Aug. 07
CANADIAN DOLLAR DENOMINATED BONDS				
ONTARIO HYDRO 10⅞% 08/01/96 (semi annual)	108 3/4	109.60	6.78 %	Jul. 08
EKSPORTFINANS 7¾% 5/11/97	100.65	101 ½	7.32 %	Nov. 05
ROYAL BANK OF CANADA 9⅛% 7/1/97	103.90	104 3/4	7.51 %	Jul. 07
SOUTH AFRICAN RAND DENOMINATED BONDS				
ESCOM 11% 31/10/93 (semi)	98.80	99.65	12.36 %	Oct. 30
AUSTRALIAN DOLLAR DENOMINATED BONDS				
COMMONWEALTH BANK OF AUSTRALIA 14% 01/07/94	107.15	108	5.56 %	Jul. 07
NEW ZEALAND DOLLAR DENOMINATED BONDS				
NEW ZEALAND GOV'T 10% 15/7/97 (semi)	109.47	110.32	7.02 %	Jul. 15
ARGENTINEAN PESO DENOMINATED BONDS				
ARGENTINA BIC V FIXED/FLOATING 1/05/2001 callable in full on every interest date	92.30	93.15	13.06 %	4th day of mth.
U.S. DOLLAR DENOMINATED FIXED CONV. BONDS				
DATAPOINT CORP. 8⅞% 1/6/06 CV @ $18.11 p/sh (semi)	78 ½	79 ½	12.40 %	Jun. 01
BURNUP & SIMS 12% 15/11/00 (semi) CV @ $16.79 p/sh	90	91	14.48 %	Nov. 15
ATARI CORP. 5¼% 29/4/02 CV @ $16.31 p/sh	51	52	15.62 %	Apr. 29
COEUR D'ALENE 6% 10/6/02 CV @ $26.00 p.sh	100 ½	102	5.71 %	Jun. 10
U.S. DOLLAR DENOMINATED FIXED RATE BONDS				
FARM CREDIT CORP. 7¾% 10/06/96 RRSP eligible	107 ½	108.35	4.64 %	Jun. 10
U.S. DOLLAR DENOMINATED FLOATING RATE NOTES				
UNITED KINGDOM 24/09/96 3 mo. LIBID-⅛ (qtly) *callable @ 100	99 3/4	100.05	3 1/16 %	Jun. 30
BOCON 1/4/01 starting to accrue May 1, '97	75 ½	76.35	10.16 %	May 1/97
ARGENTINA: SERIES L: FRB 31/03/05 6 mo. LIBOR +13/16 (semi)	71 ¼	72 ¼	12.43 %	Sep. 30

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

HOTLINE UPDATE

Wednesday, May 19:
Via flash update, we liquidated December S&P 400 strike put option at 5.60.

Tuesday, June 1:
There are no changes or new recommendations. The market letter is in the mail.

Friday, June 4:
There are no changes or new recommendations. The market letter is in the mail.

Tuesday, June 8:
There are no changes or new recommendations. The market letter is in the mail.

Friday, June 11:
There are no changes or new recommendations. The market letter is in the mail.

Tuesday, June 15:
There are no changes or new recommendations. The market letter is in the mail.

Friday, June 18:
Be sure to be aggressively short in the crude oil, add to short positions, and/or purchase slightly out-of-the-money put options. They are being "given away."

Flash Update, Tuesday, June 22, 9:00 a.m.:
Buy September S&P at the market, place initial stop at 442.00, anytime.

Tuesday, June 22:
This is a repeat of the flash update this morning at 9:00 a.m.: Buy September S&P at the market, place initial stop at 442, good anytime.

There are no other changes or new recommendations.

Flash Update, Friday, June 25, 9:10 a.m.:
Buy December gold and December silver at the market. Place initial stops at 364.00 and 421.00, respectively, good anytime. December gold currently trading at 382 and December silver trading at 455.

Friday, June 25:
This is a complete summary since our last market letter dated May 30 of all liquidations of open positions and new recommendations that remain outstanding.

On Friday, June 18, we renewed our advice to aggressively add to our short position in crude oil, via futures and/or put options.

On Tuesday, June 22, via flash update, we bought September S&P at 447.40, placing initial stop at 442.00, anytime.

On Friday, June 25, via flash update we bought December gold at 378.30 and bought December silver at 453.00, placing initial stops at 364.00 and 421.00, respectively, good anytime.

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