

FRIEDBERG'S

COMMODITY & CURRENCY COMMENTS

Friedberg Commodity Management Inc.



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Sell high, buy low

Thirteen years ago, almost to the day, saw the end of the most spectacular bull market in modern history. From a low 96.4 on October 1971, the Commodity Research Bureau Index rose to a high of 337.6 a mere nine years later. Since then, internationally-traded raw material prices have traced a broad downward zigzag, with two bottoms occurring just under the 200 level, in mid-1986 and mid-1992 (see Chart 1).

At the August 1992 lows, the index was no higher than the level attained in mid-1973, in the midst of OPEC's dramatic quadrupling of oil prices.

The laborious rise from the 1992 lows, 198.17 to 225 at this time, masks a significant and very powerful uptrend in breadth (see Chart 2) that almost certainly portends a new bull market in internationally-traded raw material prices.

The great majority of economists, lulled by the good behaviour of unit labor cost, are forecasting moderate rates of inflation for 1994 and 1995. The numbers most readily being bandied about are 2.5% to 3% per annum. They are in for a rude awakening.

Labor behaviour (as well as economists' behaviour) is inertial: A deceleration in the rise of the general price level necessarily affects inflationary expectations, which in turn affects labor demands. In effect, wage costs have been well contained because the preceding rise in prices has been contained. Wage costs *react* to inflationary expectations, they hardly ever produce them.

The great 1980-92 bear market in commodity prices — which in turn gave rise to subdued inflationary expectations — was partly caused by better monetary discipline (at least in the 1980-82 period), dramatic technological advances in the production of most commodities, and debt problems on the part of the producers. But most of all, it was a natural reaction to the extraordinary rise in prices of the decade of the 1970s. In commodity after commodity, high real prices brought forth huge increases in supply. Given the semi-recessionary conditions of much of the 1980s and early 1990s, the increments in supply translated into sharp falls in real commodity prices.

If the rise in prices of the '70s gave rise to the painful bear market of the '80s and early '90s, the same logic tells us that the falling and very low prices of the '80s will produce a bull market in the rest of the decade.

Most important of all, it should be clear that inflation was never dead in the last 13 years *despite* the fall in commodity prices. Instead, monetary inflation manifested itself in another class of goods: asset prices.

The real estate bubble in the Nordic countries, North America, and the UK, all in the mid-'80s, and Japan in the

late '80s, were all a manifestation of a monetary system out of control. The stock and bond market bubble of the past six years is, too, just such a manifestation. Incredibly, the IMF has recently admitted to this phenomenon and has even suggested that Irving Fisher, the greatest American economist, may have been right after all, in calling attention to asset inflation. Central bankers in Europe and North America do not agree, or do not seem to care.

Be that as it may, asset inflation does not have a significant effect on labor's inflationary expectations. It does not dawn on labor that its purchasing power *vis à vis* housing has diminished. (This irrationality may be explained by the fact most capital goods are purchased on credit and the cost of credit — whether by direct central bank manipulation or merely the result of a virtuous circle of low inflationary expectations — has fallen more than sufficiently to compensate for the higher capital goods prices).

The same is true with regards to stock prices: The worker's wage no longer bears the same relationship to the value of a specific share of equity in a corporation. In short,

In this issue

- 2 Commodities**
Cocoa, grains, precious metals, sugar
- 3 Interest Rates**
Leaving behind the Magic Kingdom
- 4 Stock Indexes**
Take the plunge!
- 5 Crude Oil**
Sharply lower prices ahead
- 6 Saudi Arabia**
Riyal devaluation imminent
- 6 Japan**
NIKKEI down, yen down
- 7 Canadian Dollar**
A super-cheap dollar is on the way
- 7 Africa** — Côte d'Ivoire and the CFA franc crisis: an investment opportunity?
- 8 Friedberg Capital Markets**
Assessing downside risk, TWA

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

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

asset inflation does not stir wage demands. Goods and services inflation does.

It is thus easy to understand the languid pace of unit labor cost.

Great technological advances in productivity coupled with a very natural bear market in commodities almost offset the persistent and odious rise in all forms of indirect taxation, producing a very mild rise in general prices. It is not that

inflation is dormant; it is much worse. Inflation is alive and awake, but thus far has only affected asset prices. As any mutual fund holder will tell you, the effects are pleasing and virtuous. But as our Charts 1 and 2 indicate, the pleasant and virtuous part of inflation is coming to an end and the harsh part is about to begin.

Asset inflation is giving way to commodity inflation. Sell high, buy low.

Chart 1

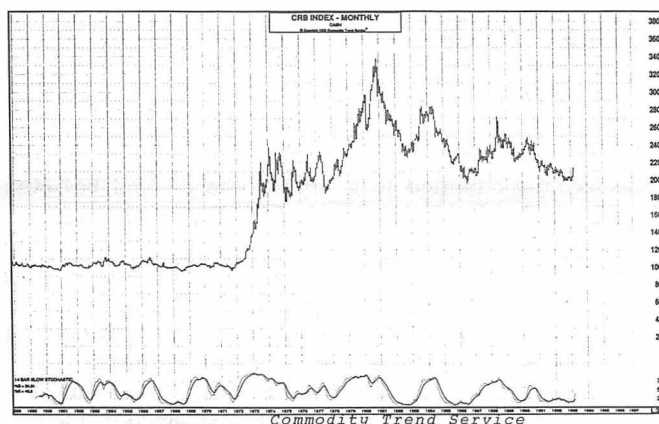
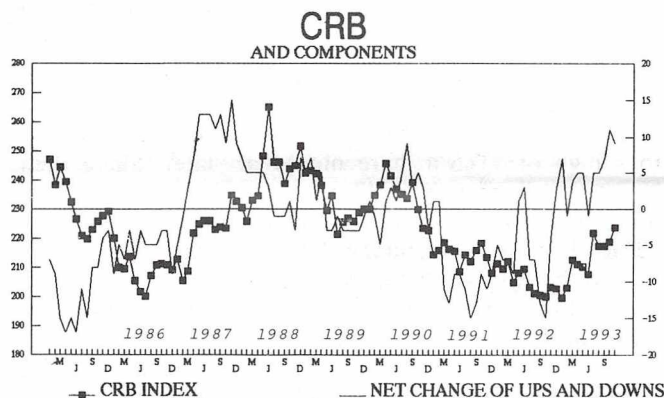


Chart 2



COMMODITIES

The recent ascent of the Commodity Research Bureau (CRB) benchmark index to above the index's previous three-year high of 222 confirms the bull market. As in the commodity bull market of the 1970s, foods will lead the advance. Industrial commodities — especially oil and copper — will lag until industrial production in OECD countries picks up. Precious metals will continue to accompany foods in the initial stage of the bull market.

Following are individual recommendations.

Cocoa

The market's current advance to above \$1,250 per tonne (basis the nearest futures contract in New York) reflects concern about the quality of deliveries at the port of Amsterdam and the threat of suspended deliveries from politically-troubled Nigeria.

The sharply narrowing spreads between delivery months (now 5% annualized, versus 15% just six months ago) indicates that for the first time in a decade, producers are concerned about obtaining supplies.

Furthermore, the rejection of shipments in Amsterdam suggests at least some of the cocoa stored — now for years in the wake of the production surpluses that persisted from 1983 through 1991 — may be no more than statistics, i.e., unusable.

A test of the 1991 highs of \$1,330 now is certain. The move ultimately confirms the underlying fundamentals. The current marketing year (which began September 1) will be the third consecutive year of deficit production.

It takes eight to 10 years for coca plants to achieve their fruit bearing stage. With the single exception of Indonesia (which, in the next three years, is expected to produce 400,000 tonnes, second highest behind Ivory Coast), no producing nation has increased its plantings of new trees since the mid

1980s. On the contrary, the low prices that persisted in sync with the eight years of surpluses have caused many nations to rip up trees and switch to other crops. Many producers that maintained acreage have practiced poor husbandry, leaving crops prone to pod rot and witches broom disease.

Consumption, on the other hand, has increased steadily. Because of the recession in Europe and Japan, and because of the downward economic spiral in the former USSR, grindings during the current marketing year may (or may not) show some negative exception to the 4% average annual rate of growth the industry has enjoyed over the past decade. Per capita consumption in developed nations has increased at 2% annually. In addition, rapidly developing Asian nations represent enormous opportunities for confectionery businesses.

Sooner or later big "shortages" will develop. Eventually cocoa prices will have to at least double to bring supply and demand into equilibrium.

STRATEGY: Remain committedly long. Maintain stops at 900 per tonne basis nearest futures contract.

Grains

The United States Department of Agriculture (USDA) report of November 9 put ending corn stocks for the 1993-94 marketing year at 881 mln bushels. The number is 20% less than estimated as recently as October and 58% less than at this time last year.

Year-end stocks of soybeans are estimated 16% lower than they were last month and 42% less than they were last year. In the case of both corn and beans, ending stocks are estimated to be the lowest they have been since the drought year of 1988.

Of special note: At 170 mln bushels, soybean stocks are

estimated at 9.4% of usage. In the past, whenever year-end stocks have declined to less than 10% of usage, soybean prices have tended to rise exponentially. At beneath 10%, users clearly feel an inadequate margin of insurance exists.

Corn and beans are at the vanguard of the commodity price advance. We were (tragically) stopped out of long futures positions in soybean meal in early October. However, investors in our Managed Options Account and many readers are currently long calls, which are destined to pay huge dividends. They may still be bought relatively cheaply.

Precious metals

We discussed the gold market at length last month. The steady advance since then confirms our bullish sentiment.

An important question begged by the article in last month's *Comments* was: At what point would producer forward selling abate? Along with official and quasi official mobilizations, producer forward selling is the major source of supply making up the deficit between usage and new production.

A recent survey conducted by Sanwa McCarthy Securities of Toronto shows that producers used the run-up that occurred in the 2nd quarter as an opportunity to increase their hedges. The increased hedging added about 85 tonnes of supply to the market. As of July 1st, 55% of 1993 production was hedged at an average price of \$361 per ounce, and 36% of 1994 production was hedged at an average price of \$376. Of the hedges applied, 40% were through spot deferred contracts, and 40% were through puts that were financed by granting calls in the neighbourhood of \$400.

There are several inferences to be gleaned from the Sanwa Survey.

For the gold market to have been as resilient as it has in the wake of the increased forward sales suggests the market may have welcomed the added liquidity. The entire open position of the Comex is less than \$6 billion whereas the speculative commodity funds in the US have capital in excess of \$24 bln, the vast majority of which has been limited to trading currencies. In this regard, producer forward sales may represent a version of the IMF sales during the 1970s.

Those sales, by providing liquidity, enticed buyers to the market who would otherwise have been forced to stay inert.

A second, and more obvious, inference to draw is that at \$361, producers are already suffering an opportunity loss. This is the first time since the technique of forward selling was devised in the 1980s that producers have suffered a loss as a result of the practice.

Finally if 40% of producer hedges are via puts financed by granting calls, and 55% or 3.86 mln ounces of production are hedged, it means 1.54 mln ounces are callable (at, as we said earlier, an average price of \$400 an ounce). If gold should cross \$400 and producers suddenly decide to cover even as little as 10% of those calls, we will see a price explosion unlike anything any of us can imagine.

STRATEGY: *Remain committedly long. Stops at 345 basis June gold, and 390 basis July Silver.*

Sugar

Statistician Czarnikow and Co., in the firm's second estimate of production for the current 1993-1994 marketing year, projected a deficit 2.18 mln tonnes. The deficit would follow one of 1.13 mln tonnes last year and would leave year-end stocks as a percentage of usage at the lowest level in 14 years.

Furthermore, the size of the deficit assumes Chinese production of 7.6 mln. tonnes. Traders at E.D. and F. Man in Japan have gone on record saying harvested area in China is down 10% from last year and, as a result, the Chinese crop will come in at less than 7.0 mln tonnes.

Premiums for sugar from Thailand (the Southern hemisphere's residual supplier) have firmed considerably in recent weeks in expectation of cash purchases from China and India.

We expect the market to shoot above the 10¢ to 12¢ trading range that has bordered it for the past 18 months and join the commodity parade to much higher ground.

STRATEGY: *Remain long with stops with stops at 935, basis May.*

— David B. Rothberg

INTEREST RATES

Leaving behind the Magic Kingdom

Long term rates are headed up.

The principal reason is the persistent rise in commodity prices (see our opening comments).

At the same time, the faster pace of economic activity in recent months is stimulating a rise in loan demand (see Chart 3) that is not likely to be accommodated much longer by the permissive Federal Reserve. In fact, just recently, the OECD called attention to the unsustainability of feeding reserves at 3% per annum when inflation was running at approximately the same rate.

Arguing that inflation-adjusted short-term interest rates have averaged about 1.25% since 1960, it proposed that the Fed raise its rates to 4.25% during the first half of 1994, abandoning its stimulative stance in favor of a more neutral one and thus pre-empting more severe inflationary pressure

than would otherwise appear in 1995 and 1996.

The OECD report, while correct in advocating higher short-term rates almost immediately, underscores the extraordinary difficulties in managing a fiat money system. Rudderless, it must "guess" the appropriate equilibrium rate of interest that will equate supply and demand for genuine savings — and it must further guess the proper timing of each adjustment; in its own words, the issue is, *when* to "rein in the stimulus."

In our opinion, *it is already much too late*. The Fed has been too easy for too long not to have to pay a steep price (see our September issue). Using a "Wicksellian rule" (see for example our article entitled "Yield curves" in our March 1990 issue) where the level of long-term interest rates is the best proxy for the "natural rate," one can estimate the length

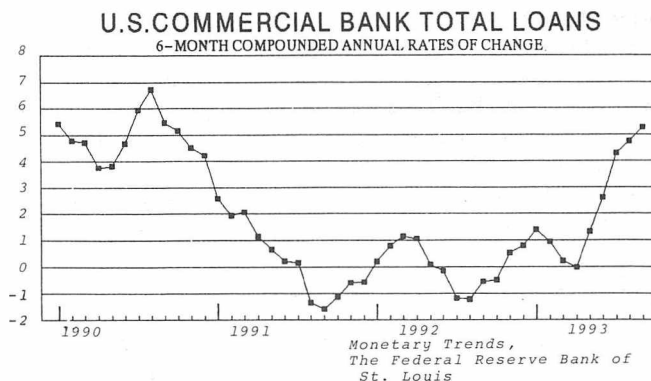
and magnitude of the folly by observing the slope on the yield curve; it has been the most positive and it has lasted for the longest period of time in the postwar period.

The OECD, and certainly the modern central bank, will continue to cause boom and bust, inflation/deflation cycles for as long as they fail to understand the weaknesses of a managed monetary system.

STRATEGY: Sell March 1994 T-bonds; use all-time highs as your initial stop. Risk-averse traders may prefer the still moderately-priced put options.

Keep in mind that the coming collapse in oil prices could, temporarily, cause a strong rally, probably sometime in the first quarter of 1994. The million dollar question is: from what level? At any rate, buyers of put options should take this potential derailment into account.

Chart 3



STOCK INDEXES

Take the plunge!

Technical and sentiment indicators have deteriorated sufficiently to warrant taking a significant bearish position.

Before mentioning a number of these omens, it should be clear that none of them are conclusive as to timing; markets have become much too sophisticated to accommodate textbook patterns. In the aftermath of 1987 and in an era of neural networks, which are capable of comparing thousands of patterns that "reliably" predict tops, it is illogical to expect an overwhelming confluence of signs that predict the end of the greatest bull market in US history.

It will come when least expected, precisely when most indicators are still flashing green. Having said that, we note faltering breadth (see Chart 4) in recent weeks ("history" tells us that breadth must fail for a number of months preceding a top), collapse in new 12-month highs (new lows exceeded new highs on both Thursday and Friday; for the week just ended, new 12-month lows equalled new 12-month highs).

There are two other interesting signs of weakness which bear no particular urgency but attest to the maturity of this bull market: The fact that the Trendline Short Range Oscillator has not produced an overbought signal (above +5) since January 1992 (!) is a clear sign of a loss of vitality, and the extraordinarily long divergence between momentum (stocks above their 30 weeks moving average) and prices (Chart 5; note lower highs in early 1992, early 1993, and now despite new highs in the indexes, a totally anomalous situation).

Courtesy of the *International Strategy and Investment* newsletter dated Nov. 17, we make two surprising observations: Since 1991, the price of new issues has increased 2.7 times more than the S&P, and an asset allocation survey conducted by the Bank of America shows that Wall Street is the most bullish on stocks since 1987 (64.5% in stocks, up from 45% in late 1988). Just in case you did not catch the Boston Chicken new issue, we're happy to inform you that sentiment on the street is red-hot.

Fundamentals. Well, fundamentals are good for a change, which should make the topsy-turvy world of Wall Street quite uncomfortable. And that is because commodity prices are

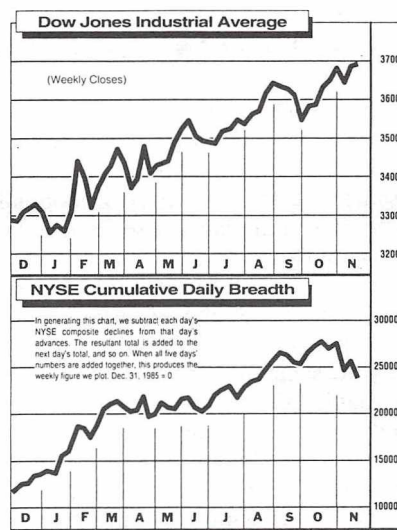
rising and interest rates, too. Just note (Chart 6) what a 15% rise in short-term rates can do to stock market returns: With the exception of Jan. 1979, all such rises produced sharp corrections in the S&P 500 over the ensuing six months, or, at the very least *suboptimal* results (a lower return than the three-month T-bill). This week, T-bill rates averaged 3.12%, a 16% rise above their October 1992 lows of 2.69% (weekly averages).

It has always been most difficult to predict market tops. We should know: every time we have attempted it, we have burned our fingers. Nevertheless, we feel that the rewards, at this time, will justify the risks.

Take a plunge!

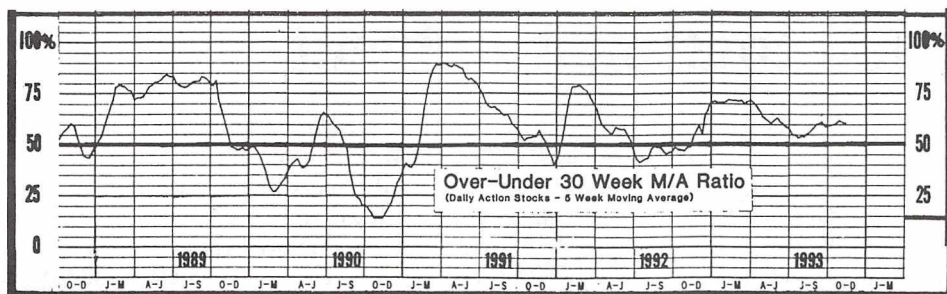
STRATEGY: Bears should go for outright short sales: Sell March 1994 S&P futures at market and risk a close above 471.50. Chickens prefer options: Buy March 440 puts at just under 400 points.

Chart 4



BARRON'S

Chart 5



Daily Action Stock Charts, Trendline

Chart 6

Cash signals

Decision date	Ensuing 6-month return S&P 500*	T bills
July 1987	-17.4%	2.9%
Jan 1984	-4.8	4.6
Jan 1979	9.9	5.6
Jan 1978	3.2	4.6
July 1977	-3.0	2.9
Jan 1974	-10.2	2.8
July 1973	-4.9	3.9
Jan 1973	-10.4	3.9
Average:	-4.7	3.9

*Includes dividends.

By Charles E. Babin
Forbes, November 22, 1993

CRUDE OIL

Sharply lower prices ahead

OPEC's exercise in self-restraint has had little or no effect on the markets. Crude prices are once again threatening the September lows (see Chart 7), while the six-month contango has once again moved out to over \$1/barrel. This is the clearest sign of persistent oversupply.

The cartel is no longer operative. OPEC is merely an association of oil producers that monitors markets and attempts to accommodate each member's desire for full production in as diplomatic and esoteric a fashion as possible. In effect, every member of OPEC is *de facto* producing at 95% of capacity, which for all practical purposes is the equivalent of full capacity.

Only once, in the 1984-85 period did OPEC exercise real self-restraint, acting like a true cartel: production was cut back more than 5 million barrels per day; and the entire burden of the adjustment fell squarely on Saudi Arabia. Still enjoying some of the extraordinary financial strength earned in the late '70s and early '80s, the Saudis became the ultimate swing producers, cutting output to as little as 2.7 million barrels per day (mbd).

Cartels are as strong as their weakest members in the absence of a generous Sugar Daddy. Since most OPEC members are financially weak, it stands to reason that the cartel can survive only with an extremely strong and generous Saudi Arabia. As we explain in the following article, this is no longer the case. Saudi Arabia is nearly bankrupt. As much as

it wishes to sustain the cartel, it can no longer afford to. The Saudis cannot bank on maximizing revenues by lowering production. In fact, the opposite is true, as the benefit of higher prices accrues to all producers, and the higher prices are not large enough to compensate Saudi Arabia for its cutbacks.

As we observed in previous issues, this is a classic bear market. Producers will not be galvanized into a collective cutback until they face a major shock. Iraq's reentry to the world markets may be just that shock. At this point, however, the threat hangs over the market as a sword of Damocles: It pressures prices but it does not elicit a forceful response.

In the end, given Russian exports, increasing North Sea output, and continued economic weakness in Europe and Japan, OPEC may never be able to tailor its output to global demand. We truly believe that this in fact will be the most likely outcome — a free-for-all that will drive prices close to their marginal cost of production. In the *very* long term this will be the Gulf producers' best strategy given their enormous underground reserves.

Expect sharply lower prices ahead. Our target remains in the single digits.

STRATEGY: Remain short March crude oil. Deferred put options are still a good buy, with at-the-money implied volatilities of 24.5%.

Chart 7
CRUDE OIL



SAUDI ARABIA

Riyal devaluation imminent

Western press reports in September insinuated that Saudi Arabia was broke. We are *certain* that this is the case.

Having run budget deficits continuously since the early '80s and having borne the principal cost of the Gulf war, estimated at over \$60 billion for just their share, the Saudis have run down their *net* international reserves to practically zero. And while the Saudi Arabian Monetary Authority (SAMA) can still count on a special reserve of hard currency that exceeds \$20 billion, it is quite likely that this amount and much more has already been hypothecated.

Commercial banks are reported to be holding \$20 billion, or 40% of their deposits, in government debt. To top it off, the Saudis have run trade deficits continuously since 1983 despite the fact that they are the world's largest producer of oil, whose price has been maintained artificially many times above its long-run equilibrium. The Saudis have lived well beyond their means, literally frittering away their wealth in less than 15 years.

What better sign can there be that trouble is brewing than that the IMF lacks information since the second quarter of 1992 regarding the Monetary's Authority's balance sheet? And that, furthermore, it provides absolutely no information on government finances (normally, lines 80 through 89 in the International Financial Statistics published monthly by the IMF)?

What about the fact that the country's largest commercial bank, the National Commercial Bank, has not issued an audited financial statement in three years? The bank's last audited statement, dated May 15, 1990, disclosed that "certain loans and advances granted to clients and partners" were in violation of Saudi banking law.

To make matters worse, the bank is fighting a \$10 billion claim brought by the liquidators of the infamous Bank of Credit and Commerce International. The personal solvency of the rulers of the Kingdom may be at stake.

In recent weeks, pressure has intensified on the Saudi riyal, which since 1986 has remained fixed to the dollar at a

rate of 3.75 riyals. Heavy SAMA intervention has kept the parity intact but at what we presume is a heavy cost in lost reserves. One can sense this pressure by observing the movement in interest rates: They have recently spiked from parity with LIBOR to 400 basis points above LIBOR. Intervention is drying up domestic liquidity; a banking system studded with bad and nonperforming loans can ill afford a cash-starved money market and an inverted yield curve.

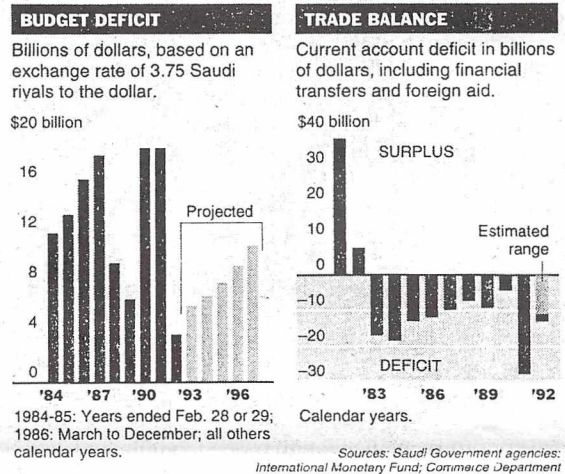
A devaluation, or downward float, is imminent.

STRATEGY: Sell Saudi riyals in the interbank forward market. Take advantage of the still reasonable 6-12 months' cost of funds.

Chart 8

Hemorrhaging Wealth

Neither Saudi Arabia's Government nor the economy have lived within its means since oil prices dropped precipitously in the 1980's.



The New York Times

JAPAN

NIKKEI down, yen down

Japan is trapped in an extraordinarily severe debt deflation with only two avenues of escape: Sizeable tax cuts and/or a massive devaluation.

Corporate results released in recent days speak of a grossly overvalued currency. Some of the world's most efficient global traders are presenting catastrophic financial results. Sony reported an 83% drop in operating earnings (to only ¥2 billion), saying that the yen's rise cost the equivalent of about ¥74 billion in sales. For the same reason, Mitsubishi's trading transactions fell by about ¥600 billion.

So far, 771 companies have reported unconsolidated half-year results to September, revealing a 26.2% fall in pre-tax profits and a 7.7% decline in sales from a year earlier. A large 24%-40% devaluation would stimulate an export-led recovery but would probably put unbearable stress on the world trading order, bringing forth strong demands for trade protection in the US and Western Europe. Eventually, however, if allowed to work its way through, a rising trade surplus would stimulate domestic demand, which would in turn narrow the surplus, as in 1987-91.

A better and politically more feasible option is to stimulate domestic demand via an uncompensated and large tax cut, narrowing the trade and current account surplus and changing in the process the dynamics of the post-war Japanese economy, from a high savings to a low savings one. It will have the added benefit of stilling protectionist sentiment in the Western world.

In this scenario, the yen should fall only moderately, to perhaps ¥120-125 to the dollar. Which one will it be?

The betting at this time is that the coalition government will try to put through a modest ¥5,000 billion tax cut, compensated two years later by a sales tax increase. Such a plan would see little, if any, chance of success; the economy would continue to sag and stock prices would collapse. As the fiscal

year comes to an end, the coalition may, however, stumble on the right policy — a large and unconditional tax cut.

In sum, if the export-led recovery option is adopted, the yen will need to fall as much as 40%. If, on the other hand, the government chose to reflate via tax cuts, the yen may need to fall only 20% from its highs. Either way, the yen represents an ideal short sale. And, at least until it stumbles on the right policy, the NIKKEI should head a great deal lower.

STRATEGY: 1. Reinstate short yen positions at the market. Place initial stops at 95.00, basis March '94, close only.

2. Remain short NIKKEI futures until it becomes clear, if it ever does, that the government will go for a massive and uncompensated tax cut.

CANADIAN DOLLAR

A super-cheap dollar is on the way

The imminent downgrading of Ontario's (and perhaps other provinces') debt will in short order shift the main burden of balancing the external accounts to the current account, now in deficit to the tune of C\$25-\$28 billion. In addition, it will force a re-opening of the US-Canada interest rate spread (now down to 80-90 basis points), with depressionary consequences for the domestic economy (although, admittedly, it should help achieve a surplus on current account).

In effect, having lost the ability to attract capital, Canada will be forced to live within its means. Furthermore,

given the much larger size of the foreign debt today compared with where it stood in the mid-'80s and its concomitant debt service burden, it will not be easy to achieve a balanced current account without the aid of a *super-cheap* dollar. Perhaps 15%-20% lower.

STRATEGY: We have reinstated short positions. Short of massive cutbacks in federal and provincial expenditures (accompanied by modest tax cuts), this short position should not be disturbed. Initial target: 70 cents. Longer term: 60 cents.

AFRICA

Côte d'Ivoire and the CFA franc crisis: An investment opportunity?

We are always in search of opportunities in places where most observers don't recognize them. Indeed, our hallmark has been to discover surprises in the investment world before they occur, because it is from those surprises that true opportunities for profits arise. At present, a situation is developing in Côte d'Ivoire that promises such a surprise and potential profit opportunities.

The Côte d'Ivoire is on the ropes. Indeed, it is almost down and out. Since 1985, the combination of weak prices for cocoa and coffee, which account for about 45% of the total value of exports, has resulted in a negative terms of trade shock of about 20%. If that wasn't enough, during the same period, the real exchange rate appreciated by 30%, cutting hard into external competitiveness. The fallout has taken on catastrophic proportions, with living standards dropping by a third during the past six years. But where there is fallout, there are opportunities. In what follows, we sketch the outlines of what might unfold in the Côte d'Ivoire.

* * * * *

The motivation for constructive reforms in the Côte d'Ivoire will center on setting a new peg for the CFA franc, which is

the common name for the currencies of 13 Sub-Saharan countries (including Côte d'Ivoire) that are pegged to the French franc at CFA 50/FF. That rate has held since 1948, which makes it one of the longest-holding currency pegs in the post-WWII era. Its durability has provided francophone Africa with a degree of monetary stability that is rare in the developing world. This currency link has also facilitated close economic and political relations among the CFA countries and between them and France. Moreover, it has become a symbolic cornerstone of French foreign policy in Africa.

The guiding principles of the CFA franc zone have been as follows: convertibility of CFA francs into French francs at a fixed parity; pooling of most CFA zone foreign exchange reserves at the French Treasury, but with separate "operations accounts" for each member country; payments guaranteed by France and cleared through the operations accounts; free capital mobility throughout the CFA franc zone; and the establishment of a common franc zone trade and financial policy *vis à vis* the rest of the world.

Until France jumped on the European Monetary Union bandwagon and adopted the *franc fort* policy, this arrange-

ment appeared to have worked rather well. However, since 1985, the French franc has been relatively strong and the CFA franc has become grossly overvalued. Indeed, most think the overvaluation is in the 50% to 60% range.

There is, of course, abundant evidence of overvaluation. For example, in 1992, CFA franc repurchases were up 50% over the two previous years, and in the first six months of 1993, they jumped by another third. Not surprisingly, each plane from West Africa to Paris is filled with rich Africans carrying suitcases stuffed full of CFA franc notes. They are hurriedly converted into French francs while the rate remains at 50:1.

As the capital flight mounted, the reserves of the CFA franc zone were eroded, and the Balladur government became less willing to replenish them. Consequently, for the first time since 1948, most convertibility was suspended on August 2, 1993, and quantitative limits were imposed on the purchase of French francs. With the limitations on convertibility, a black market sprang up. The CFA franc trades at a 25% discount to the official parity on that market. After almost a half century of stability, the CFA franc parity has started to unravel. Indeed, the suspension of full convertibility cannot be maintained for long without destroying the CFA zone. That would be an economic and political embarrassment, both to the CFA countries and to France.

* * * * *

It is clear that something must be done. The first hint of what's in store was given by France's Economy Minister Edmond Alphondery, when he addressed the CFA-zone ministers in Abidjan in September. He indicated that the CFA member states' close cooperation with the IMF and World Bank would be a condition for future French aid. Although the IMF and the World Bank have officially maintained silence since September, officials tend in private to be adamant that devaluation must take place. The institutions' hard line towards the CFA zone reflects this. Consequently, it's only a matter of time before a new parity is set for the CFA franc.

But the devaluation will not occur in isolation. Most likely it will be part of a larger reform package, which is what makes the situation so interesting. The leaders of the Côte d'Ivoire, while indicating that they want a devaluation, have also indicated that a devaluation would rattle many relatively well-off civil servants, who could cause a great many problems if the purchasing power of their wages were slashed by 50%.

Hence, the leaders are demanding that the flow of funds from the World Bank and IMF, which has all but dried up, be

opened up again. These funds might start flowing as part of a big bang package, but only if the Côte d'Ivoire agrees to significant structural reforms that have been laid out by the World Bank. These include the following: a reduction in government regulations and interventions; a comprehensive privatization program; a restructuring of commercial banks; market liberalizations; and a much greater reliance on the private sector of the economy.

So it appears that the CFA franc crisis could put in place a series of constructive reforms that will be packaged together as a big bang, one that would have dramatic positive consequences for the Côte d'Ivoire. One issue that we have not addressed is the Côte d'Ivoire's mountain of external debt. That, too, will be part of any package deal. We now turn to that matter, because therein lies one area with large profit potential.

* * * * *

Since 1980, the Côte d'Ivoire's external debt has soared, increasing from \$5.8 billion to \$21.7 billion at the end of 1992. As the debts mounted and the likelihood of repayment shrank, new private foreign loans dried up. The IMF and World Bank filled the gap, but their financial resources and willingness to supply them were also limited. When those institutions cut off funding, the Côte d'Ivoire began to run large arrears with the domestic banks. That's why the banks have to be restructured and recapitalized.

The accumulation of government debt did not itself directly threaten the CFA franc regime. However, in the case of foreign debt (apart from the World Bank and other official debt), the Côte d'Ivoire simply stopped servicing its commercial debt in 1987. Consequently, it now trades for 10%, or less, of its face value.

As part of any big bang package for the Côte d'Ivoire, that country's debt will, therefore, be restructured and rescheduled. It is there where one profit opportunity lies.

IMPLICATIONS: The CFA franc zone will be put back together with a new parity in the coming months. That will occur as part of a big bang package that also involves privatization, supply-side reforms, a host of market-friendly liberalizations, and debt restructuring and rescheduling. That big bang, coupled with improving terms of trade, will among other things push the prices of the Côte d'Ivoire's commercial external debt up sharply. It is that prospect that has drawn our attention to developments surrounding the Côte d'Ivoire. Stay tuned for a big bang.

— Dr. Steve H. Hanke

FRIEDBERG CAPITAL MARKETS

Assessing downside risk on convertibles

Approximately 35% of our managed bond accounts' assets are being invested in corporate convertible bonds, which include Atari, Burnup & Sims, Coeur D'Alene, Datapoint, and Glycomed. All these convertibles have appreciated to different extent since we bought them for our clients. The appreciation is largely due to rallies in their respective stocks. When most investors are concerned about a possible stock market correction to be triggered by a rebound in interest

rates, we believe it is time for us to assess the downside risk of the convertibles.

To assess the downside risk, we have to estimate the investment value of the bond. In other words, without the equity participation, how much should the bond be worth? The most direct way to make the estimate is to find a straight bond that has the same credit rating, currency denomination, liquidity and a similar maturity date (it is often difficult

to find a bond with exactly the same maturity date). If the yield on such a bond (if more than one bond, use the average yield) is higher than the convertible's, it indicates that the convertible's price has incorporated a premium for the conversion option. Discounting the convertible's cash flow using the straight bond's yield will give us the investment value.

Chart 9 lists the credit rating, recent price/yield, comparable straight bond's yield and the resulting investment value of each convertible.

Chart 9 shows that, except for Burnup & Sims, the prices of all the other four convertibles have included a premium for the conversion option. Coeur D'Alene has the largest downside risk of 31%. We believe the reason is that Coeur D'Alene's stock has moved up rapidly to close to the conversion level (\$21 vs. \$26) because of the bull run on the gold and silver markets, while the fundamental financial position of the company has not improved correspondingly.

Burnup & Sims is an interesting case since the yield on the comparable straight bond is almost 200 basis points lower. There are two possible explanations for this: a) Burnup & Sims' bond should have been downgraded; b) the market has mispriced the bond. To find out which one is more likely, we have to examine the financial position of the company. Chart 10 gives the key financial ratios of the five companies.

Although Burnup & Sims has a low current ratio, it is the only company that has positive pretax interest coverage, and it has the highest operating cash flow coverage, which are two most important measures of debt-servicing ability. Therefore, despite its relatively high leverage, we believe it is reasonable to place Burnup & Sims one grade above the other four companies. Based on a 10.75% yield, Burnup & Sims' convertible can trade up to \$106, which represents a 7% potential appreciation. Even if we treat it as a CCC-rated bond, which should yield 11.38%, the investment value will be \$103, still above the current market level.

Our conclusion is that Burnup & Sims' convertible is

being undervalued. The market may be worried about its recent merger with Church and Tower Inc., which is a private company that few investors have information on. The above comparison effectively reinforces our recommendation on Burnup & Sims in our market letter last month, which was based on good asset coverage.

For the other four convertibles, although our analysis indicates that there is downside risk of varying magnitude, we will keep them in the portfolio as long as we believe their stock still has upside potential.

Chart 9 – INVESTMENT VALUES

Issuer	ATC	BSIM	CDE	DPT	GLYC
Credit rating	CCC2	B3	CCC2	CCC2	CCC2
Recent price (per \$100)	\$72	\$99	\$101.5	\$87.5	\$90
Yield	10.39%	12.59%	5.77%	11%	9.35%
Maturity (mm/dd/yy)	4/29/02	11/15/00	10/6/02	6/1/06	1/1/03
Yield on straight bond	11.38%	10.75%	11.38%	11.84%	11.38%
Investment value	\$67	\$106	\$70	\$81	\$78
Downside risk	7%	Nil	31%	7%	13%

Chart 10 – KEY FINANCIAL RATIOS

Issuer	ATC	BSIM	CDE	DPT	GLYC
Credit rating	CCC2	B3	CCC2	CCC2	CCC2
Current ratio	5.6	1.8	11.4	1.5	2.7
Pretax interest coverage	(22.6)	0.5	(1.0)	(0.1)	(4.7)
Pretax operating cash to interest	(0.8)	1.6	0.3	0.4	(3.3)
Debt to equity	1.6	1.8	0.8	2.4	1.3

TWA's new bonds and stocks start trading

TWA officially emerged from Chapter 11 on November 3, 1993. Its new common stock, preferred stock, seven-year notes and ten-year notes started trading on a when-issued basis on the American Exchange the following day. The most recent prices of these securities are as shown in Chart 11. (All prices quoted are offer prices).

We have tried to obtain the finalized allocation figures for the 15% and 17.25%/16% notes that we have recommended. However, since TWA has not announced the exact figures yet (expected to be available in a week), we can use only our best estimates. However, we believe the final distributions will not differ materially from those shown in Chart 12.

Some brokers and analysts recently mentioned that for the senior unsecured notes, the 17.25% will have a higher final distribution than the 16% because of a greater amount of accrued interest in arrears. We have not been able to confirm it with our sources. However, the difference should result in approximately only a 5% price difference. Therefore, we believe that the differential distribution, if there is any, will not change our previous recommendations and valuation.

Based on the above estimated distributions and the most recent market prices of the component securities, the 15% notes should be worth approximately \$117.2 per \$100, whereas

the 17.25%/16% notes approximately \$43.2 per \$100. The 15% and 17.25%/16% notes are currently trading at \$116 and \$43.3, respectively. The slight discount on the 15% notes is mainly due to the uncertainty as to when TWA will actually distribute the cash. According to the latest information, TWA will distribute the new securities in stages, and the first distribution is expected to take place in December.

We believe that the current prices of the new securities do not fully reflect their underlying value. The airline industry is coming out of a slump after all players have aggressively reduced cost, rationalized routes, and contained capacity expansion. The potential decline in oil prices (see our September and October market letters for analysis) will further cut their costs in a substantial way.

TWA, in particular, has continued to improve its operating performance. It had reported an operating profit for both June and July. It suffered a larger-than-expected operating loss for the third quarter of '93, mainly owing to the Midwestern flood that disrupted traffic at its St. Louis hub. Its strategy to offer comfort class is ingenious as it forces the industry to reduce capacity when competitors follow suit. Now that bankruptcy is behind them, the 45% employee ownership will give them a distinct competitive advantage. In short, we are still optimistic about TWA's medium-term viability.

Our analysis indicates that TWA's new fixed-income securities should trade at the yields shown in Chart 13.

We valued the common stock still on the basis of the industry's before-debt market capitalization (BDMC) to revenue ratios, as explained in our first TWA recommendation in June. However, this time we added Continental Airline to our industry portfolio. We consider it the most comparable company to TWA as it also just came out of bankruptcy. Chart 14 lists the BDMC to revenue ratios of the six airlines.

The average BDMC to revenue ratio of the six airlines is 1.07. However, Continental has the lowest ratio, which is reasonable owing to the higher perceived risk for a company which just emerged from Chapter 11. Therefore, we applied the 0.89 ratio to TWA's revenue in the last four quarters (first half of 93 and second half of 92), which is \$3.25 billion, to obtain a BDMC of \$2.9 billion. If we take off a projected total debt of \$2.58 billion (end of 93), TWA's equity should be worth \$318 million. Since we valued the preferred stock at \$4.1 per share, the common stock value can thus be derived at \$13.3 per share. We believe that based on TWA's prospects

and the airline industry's improving performance, TWA's BDMC to revenue ratio should be in the range of 0.88 to 0.9, which means a projected common share price of \$11 to \$14.

According to our valuation of the new securities, the 15% senior secured notes should have a fair value of \$129.6, while the 17.25%/16% notes' fair value is approximately \$55.9 (based on \$11 per common share — the low side of our estimate). These estimates represent a further appreciation potential of 11.7% and 30% for the 15% and 17.25%/16% notes, respectively.

STRATEGY: We recommend that investors who already have TWA's old bonds hold on to them until the new securities are issued, after which their prices should slowly approach our targets. However, we wish to reemphasize that although the 17.25%/16% senior unsecured notes have a stronger upside potential, the risk is higher than the 15% notes because of the stock components and the weak asset coverage on the new 7-year notes.

— Edison Lee

Chart 11
TWA SECURITIES AND PRICES

Securities	Price	Yield
Common stock	\$6.75 per share	Nil
Preferred stock	\$3.625 per share	25.5%
8% 7-year notes	\$45 per \$100	24.3%
10% 5-year notes	\$76 per \$100	17.7%

Chart 12
FINAL DISTRIBUTIONS

Old Bonds	Package
15% senior secured notes	\$440.03 cash and \$963.4 face value of new 10% five-year notes.
17.25% and 16% senior unsecured notes	21 preferred shares, 12.7 common shares, and \$595 face value of new 8% seven-year notes.

Chart 13
YIELDS

Securities	Projected Yield	Implied Price	Reasoning
Preferred stock	23%	\$4.1 per share	High dividend, but not until 95. Junior ranking relative to bonds.
8% 7-year notes	19%	\$56 per \$100	Moderate asset coverage. 8% premium over most CCC rated bonds.
10% 5-year notes	13%	\$89 per \$100	Good asset coverage. All interest payments in cash.

Chart 14
REVENUE RATIOS

	Contnl	Delta	Alaska	USAir	UAL	AMR
Mkt cap of stock (\$m)	400	3,015	218	666	3,422	5,238
Total debt (\$m)	4,553	9,875	981	5,827	12,315	15,399
Revenue of last 4 quarters (\$m)	5,539	11,997	1,110	6,916	14,072	15,328
BDMC to revenue	0.89	1.07	1.08	0.94	1.12	1.35

Chart 16

RECOMMENDED CURRENT PORTFOLIO ALLOCATIONS

New TWA	15%	10%
New Zealand Gov't		10%
Fletcher NZS		15%
CIL NZS		5%
FRB/BOCON		30%
Burnup & Sims		5%
Datapoint		5%
Coeur D'Alene		5%
U.K. FRN		5%
Deutschemark		10%

Chart 15
FOREIGN CURRENCY BONDS

Date: November 18, '93 We Offer The Following Bonds Subject To Change Without Prior Notice: Minimum US \$4,000 (CDN. \$6,000)

ISSUER/MATURITY DATE/COUPON	BID	OFFER	CURR. ANNUAL YLD. TO MTY.	NEXT PAYMENT INTEREST DATE
DEUTSCHE MARK DENOMINATED				
BANK OF NOVA SCOTIA 5 $\frac{3}{8}$ % 07/05/96 RRSP eligible	99.40	100 $\frac{1}{4}$	5.50 %	
WORLD BANK 5 $\frac{7}{8}$ % 4/02/97 RRSP eligible	102.85	103.70	4.60 %	May 07
WORLD BANK 9% 13/11/00 RRSP eligible	119.65	120 $\frac{1}{2}$	5.39 %	Feb. 04
KINGDOM OF DENMARK 6 $\frac{1}{8}$ % 15/04/98	102.45	103.30	5.28 %	Nov. 13
ARGENTINA 8% 5/10/98	100 $\frac{1}{4}$	101.10	7.71 %	Apr. 15
				Oct. 05
FINNISH MARKKA DENOMINATED BONDS				
REP. OF FINLAND 11% 15/6/95	106 $\frac{1}{2}$	107.35	5.87 %	Jun. 15
ITALIAN LIRA DENOMINATED BONDS				
NORDIC INV. BANK 12 $\frac{3}{8}$ % 19/04/96	107.10	107.95	8.52 %	Apr. 19
GENERAL ELECTRIC 11 $\frac{1}{2}$ % 7/02/95	102.35	103.20	8.51 %	Feb. 07
SWISS FRANC DENOMINATED BONDS				
GENERAL ELECTRIC 4 $\frac{3}{4}$ % 2/7/98	103.05	103.90	3.81 %	July 02
DANISH KRONE DENOMINATED BONDS				
KINGDOM OF DENMARK 9% 15/11/94	101.40	102 $\frac{1}{4}$	6.52 %	Nov. 15
ECU DENOMINATED BONDS				
UNITED KINGDOM 9 $\frac{1}{8}$ % 21/02/01	115 $\frac{3}{4}$	116 $\frac{3}{4}$	6.18 %	Feb. 21
BRITISH POUND DENOMINATED BONDS				
KGDM OF SWEDEN 8 $\frac{3}{4}$ % 29/5/96	105 $\frac{3}{4}$	107	5.66 %	May 29
FRENCH FRANC DENOMINATED BONDS				
CREDIT LYONNAISE 9 $\frac{1}{2}$ % 23/12/96	109.65	110.65	5.63 %	Dec. 23
JAPANESE YEN DENOMINATED BONDS				
WORLD BANK 5 $\frac{3}{4}$ % 7/8/96 RRSP eligible	108.15	109	2.27 %	Aug. 07
CANADIAN DOLLAR DENOMINATED BONDS				
ONTARIO HYDRO 10 $\frac{7}{8}$ % 08/01/96 (semi annual)	109.30	110.30	5.72 %	Jan. 08
EKSPORTFINANS 7 $\frac{3}{4}$ % 5/11/97	104.20	105.20	6.22 %	Nov. 05
ROYAL BANK OF CANADA 9 $\frac{1}{8}$ % 7/1/97	106.80	107.80	6.28 %	Jan. 07
SOUTH AFRICAN RAND DENOMINATED BONDS				
ESCOM 12% 1/5/96 (semi)	103.15	104	10.35 %	Nov. 1
AUSTRALIAN DOLLAR DENOMINATED BONDS				
COMMONWEALTH BANK OF AUSTRALIA 14% 01/07/94	104 $\frac{3}{8}$	105 $\frac{3}{8}$	4.54 %	Jul. 01
NEW ZEALAND DOLLAR DENOMINATED BONDS				
NEW ZEALAND GOV'T 10% 15/7/97 (semi)	113 $\frac{1}{4}$	114.10	5.66 %	Jan. 15
FLETCHER CHALLENGE 10.15% 30/11/98 (semi)	107.95	108.80	7.95 %	May 30
CORPORATE INVESTMENT LTD. 113 $\frac{1}{2}$ % 19/6/95 (semi)	83.65	86.15	22.69 %	Dec. 19
ARGENTINEAN PESO DENOMINATED BONDS				
ARGENTINA BIC V FIXED/FLOATING 1/05/2001 callable in full on every interest date	96.10	96.95	10.29 %	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)	86 $\frac{1}{2}$	87 $\frac{1}{2}$	11.00 %	Dec. 01
BURNUP & SIMS 12% 15/11/00 (semi) CV @ \$16.79 p/sh	95 $\frac{1}{2}$	98 $\frac{1}{2}$	12.71 %	Nov. 15
ATARI CORP. 5 $\frac{1}{4}$ % 29/4/02 CV @ \$16.31 p/sh	70 $\frac{1}{2}$	72	10.38 %	Apr. 29
COEUR D'ALENE 6% 10/6/02 CV @ \$26.00 p.sh	100 $\frac{1}{2}$	102	5.69 %	Jun. 10
GLYCOMED 7 $\frac{1}{2}$ % 1/1/03 CV @ \$14.06 p/sh (semi)	88 $\frac{1}{4}$	89 $\frac{1}{4}$	9.49 %	Jan. 1
T.W.A. 15% 31/7/94	114	116	-	in default
T.W.A. 17 $\frac{1}{4}$ % 15/3/93	41 $\frac{5}{8}$	43 $\frac{5}{8}$	-	in default
U.S. DOLLAR DENOMINATED FIXED RATE BONDS				
FARM CREDIT CORP. 7 $\frac{3}{4}$ % 10/06/96 RRSP eligible	107	107.85	4.40 %	Jun. 10
U.S. DOLLAR DENOMINATED FLOATING RATE NOTES				
UNITED KINGDOM 30/09/96 3 mo. LIBID- $\frac{1}{8}$ (qly) *callable @ 100	99.57	99.87	2 $\frac{15}{16}$ %	Dec. 30
BOCON 1/4/01 (30 day LIBOR) starting to accrue May 1, '97	91.40	92 $\frac{1}{4}$	7.09 %	May 1/97
ARGENTINA: SERIES L: FRB 31/03/05 6 mo. LIBOR + $\frac{13}{16}$ (semi)	83	84	7.01 %	

GOLD (in ounces, at market prices, can also be held in your bond account)

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

HOTLINE UPDATE

Tuesday, October 26:

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

Friday, October 29:

There are no changes or new recommendations.

Flash update, Monday, November 1, 8:45 am:

Liquidate long December gold and March silver at the market, cancelling existing close-only stops at 349 and 4.04, respectively. Currently, December gold is trading at 366.50 and March silver is trading at 4.30.

Tuesday, November 2:

The following is a recap of this week's recommendations. On Monday, November 1, via flash update, we advised liquidating long December gold position and long March silver positions at the market, then trading at 366.50 and 4.30 respectively.

We now have two new recommendations:

1. Change stops on short December Japanese yen position to 94, close only from 96, close only.
2. Change stops on short December Canadian dollar position to .7715, close only from .7810, close only.

Flash update, Wednesday, November 3, 1:35 pm:

1. Buy February gold and March silver at market, presently trading at 368.30 and 431½, respectively.
2. Sell March Nikkei at market in Chicago, presently trading at 195.50.

As well you may buy December 190 JPN Amex puts presently trading at 2¼.

Friday, November 5:

The following is a recap of this week's liquidations and new recommendations.

On Monday, November 1, via flash update, we liquidated our long December gold and long March silver position at market, then trading at 366.50 and 4.30, respectively, cancelling all stops.

On Tuesday, November 2, we made two recommendations:

1. Change stops in short December Japanese yen position to

94.00, close only, from initial 96.00, close only.

2. Change stops on short December Canadian dollar position to .7715, close only from .7810, close only.

On Wednesday, November 3, via flash update, we bought February gold and March silver at market, then trading at 368.30 and 431½, respectively. As well we sold March Nikkei Dow at market in Chicago then trading at 195.50. We also recommended buying Amex December 190 JPN puts at market then trading at 2¼.

Tuesday, November 9:

There are no changes or new recommendations.

Friday, November 12:

There are no changes or new recommendations.

Flash update, Thursday, November 18, 5:15 pm:

Sell March Canadian dollar at market.

Friday, November 19:

This is a complete summary since our last market letter dated October 24, 1993, of all liquidations of open positions and new recommendations.

On Monday November 1, via flash update, we liquidated long December gold and March silver positions at the market, then trading at 366.50 and 4.30, respectively, cancelling all stops.

On Wednesday, November 3, via flash update we bought February gold and March silver at the market then trading at 368.30 and 431½ respectively.

We sold March Nikkei in Chicago at the market, then trading at 195.50. As well, we recommended buying December 190 JPN AMEX puts at 2¼.

On Friday, November 5, we liquidated short December Canadian dollar positions via revised stops of .7715, close only.

On Thursday, November 11, we liquidated short December Japanese yen position via revised stops of 94, close only.

On Thursday, November 18, via flash update, we advised selling March Canadian dollar at market. March Canadian dollar opened Friday, November 19 at .7536.

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