FRIEDBERG'S

COMMODITY & CURRENCY COMMENTS

Friedberg Commodity Management Inc. Volume 15, No. 7 July 24, 1994

A time to act

It appears to be a foregone conclusion that the Fed, at its next FOMC meeting on August 16, will raise interest rates. The economy is operating ever closer to full capacity. Commodity prices, with the exception of grains, have continued their broad advance. And in recent weeks, the growth in commercial and industrial loans has begun to accelerate (see Chart 1).

To commodity traders, the most pertinent index is the Commodity Research Bureau. Unfortunately its heavy reliance on erratic and weather-affected grain prices does not always provide a realistic picture of the breadth and intensity of price pressures throughout the US economy. For this reason the Fed governors may focus their attention on a number of indexes, such as the Dow Jones Commodity Spot Index (see Chart 2) and the Journal of Commerce index of 18 industrial commodities (see Chart 3). Both of these well known indexes, as well as *The Economist* All Items dollar index, which is up 39.5% from a year ago, point to a need for monetary discipline. And while the broader monetary aggregates have been thus far relatively well behaved, the Fed has already acknowledged that there has been a substantial gain in the velocity of these aggregates due to rising interest rates.

The foregoing is not new. What is remarkable, however, is the degree of uncertainty surrounding the likely extent of the coming increase in rates. A *Wall Street Journal* survey of 58 economists produced an average estimate of 4.67% for three-month Treasury bills that at the time of the survey showed a yield of 4.15%. Similarly, their forecast for three-month Treasury bill rates for June 30, 1995 averaged 4.99%. Strangely, the expected 52 and 84 basis point jumps in rates were substantially lower than the yields implied in the futures market. In fact, on June 30, December '94 Treasury bills traded at 94.54 and June '95 at 93.98, indicating yields of 5.46% and 6.02%. That is, the market, a much broader sample than the 58 economists, had built in much more dramatic expectations of interest rate hikes, namely, 131 basis points and 187 basis points, respectively. Why such a difference?

It may be interesting to speculate on an answer. We offer the following untested, untestable, and highly speculative rationale: The 58 economists in *The Wall Street Journal* sample were not assessing what needed to be done or what was likely to happen; they were merely trying to forecast what the Fed was likely to do. As professional economists viewing other professional economists, i.e., Mr. Greenspan and his team, they projected their own personal caution and tunnel vision. If the Fed wants to conduct an effective monetary policy, however, it must extricate itself from its "professionalism" and must instead observe what the market is saying. Professionals project inertially; they extrapolate current trends and assume relatively static conditions. Markets on the other hand are creative, dynamic, and adapt very quickly to changing conditions.

Which will be right? A professional consensus around 4.67% for three-month Treasury bills on December 31, 1994? Or a market indication of a minimum (given that the December '94 T-bill expires 10 days before the end of the month) of 5.46%? We suggest that the Fed would be well advised to conduct its policy with a view to matching, in the very near term, market expectations reflected in the nine-month or 12-month futures. Interestingly, this course of action would have resulted in the Fed raising the Fed Funds rate in early January by 75 to 100 points in one fell swoop rather than the

In this issue

Contributions by Albert D. Friedberg, Edison Lee, and Thomas Klitgaard.

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

NOTE: There will be no issue in August. The next issue will appear in September. Meanwhile, stay in touch with our Hotline for up-to-the-minute reports and advisories.

nickel and dime operation conducted over the past six months. This latter course has caused market expectations to move further away from current rates than was the case in early January.

We repeat: Commodity prices are moving up, in some cases fairly dramatically. Inevitably an acceleration of inflation is on the way. The fiat money system leaves the Fed anchorless in a stormy and unpredictable sea. It can once again begin to target gold. Or, it must break away from its well-structured professional cocoon and begin to listen to the markets' siren. *It* is telling the Fed to raise rates *now* by at least 100 basis points.

Chart 1

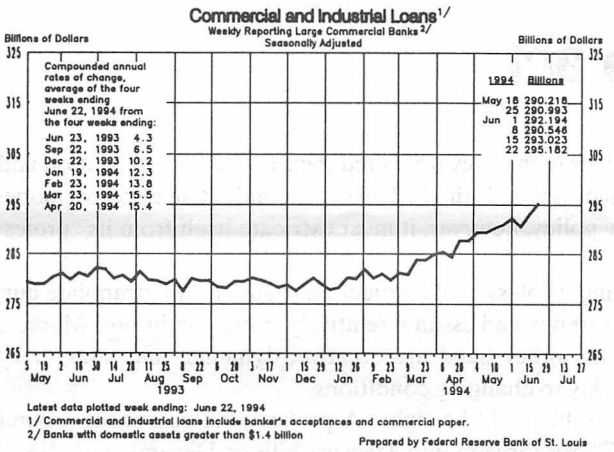


Chart 3
JOURNAL OF COMMERCE INDEX OF 18 INDUSTRIAL COMMODITIES

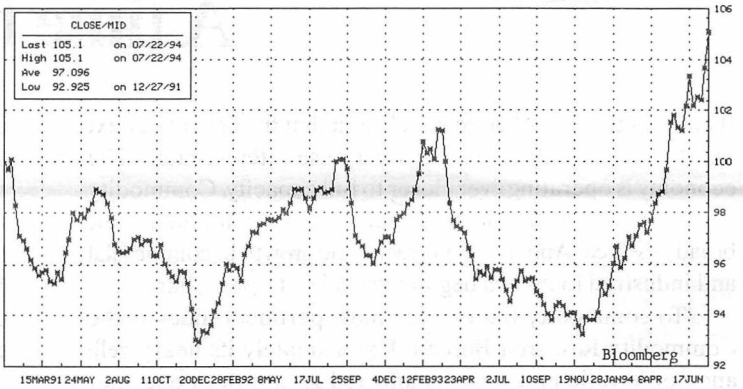
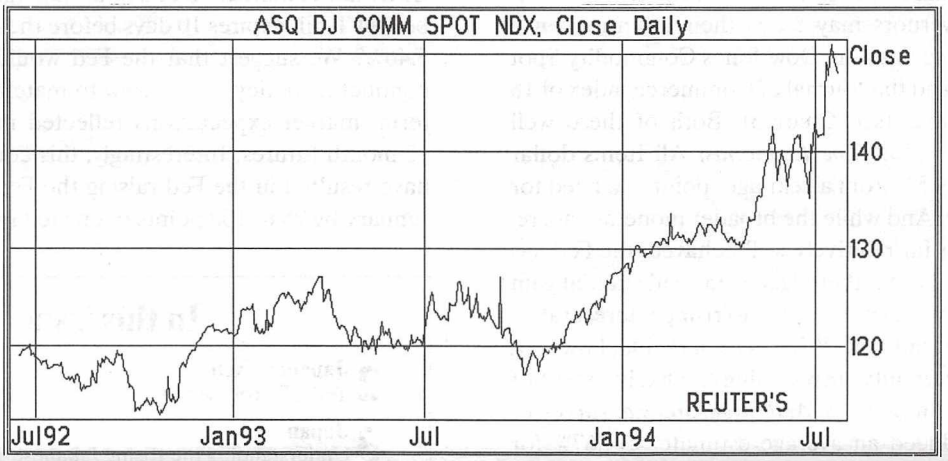


Chart 2



JAPANESE YEN

Yen/SF cross serves well

The following article explains very clearly the effects of the so called J-curve on Japan's balance of trade figures. Clearly, the yen is caught in a vicious circle: A rising nominal trade surplus stimulates yen buying, which in turn causes the nominal surplus to continue rising. Instead, a falling yen would shrink the nominal surplus in line with the already spectacular shrinkage in the real surplus and would help Japan emerge from its four-year deflationary depression.

How can this self-perpetuating rise come to an end? One way would be for interest rate differentials between the United States and Japan to widen substantially. The 300 basis point difference in the five-year and 10-year maturities seems to be almost totally accounted for by differential inflationary expectations, which is another way of saying that in real terms there is no margin in favor of US interest rates. A more determined Fed policy (see our initial comments) and a slightly more accommodative Bank of Japan could just do the trick. Alternatively, or in addition, the new Japanese coalition government could provide a substantial measure of fiscal stimulus by planning to extend the $60 billion income tax cut into the coming years without offsetting it by a rise in the 3% sales tax. This would initially narrow the trade gap via a very substantial increase in imports. Once the market perceives that the nominal trade surplus has turned, it would become a seller of yen.

Not until we see a more decisive action on the part of the Fed will we be comfortable being short yen outright. In the meantime, the cross (short yen versus long Swiss franc) is serving us well.

STRATEGY: *We are short yen and long Swiss francs on a spread basis. Stops should be maintained at 61.60, New York close, basis the more critical DM/yen cross.*

Chart 4

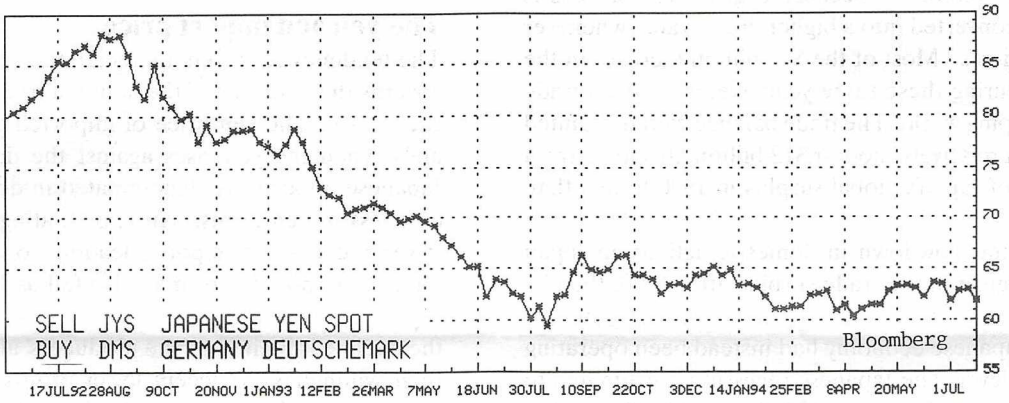
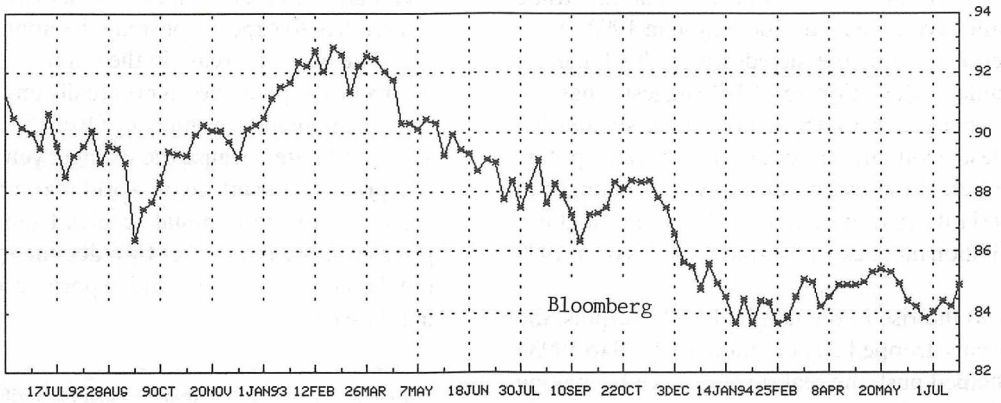


Chart 5 – SWISS FRANCS PER DM



JAPAN

Understanding the rising Japanese trade surplus

by Thomas Klitgaard

Intuition suggests that a strengthening of the yen should moderate Japan's trade surplus by reducing the price competitiveness of Japanese goods. Yet the Japanese merchandise trade surplus more than doubled from 1990 to 1993, reaching a record $120 billion, at the same time that the yen appreciated roughly 30 percent against the dollar. Is the pairing of these developments evidence of an unusual relationship between Japan's exchange rate and its trade surplus?

The answer, in short, is no. The nominal trade surplus, which is the difference between the value of exports and imports, is affected by changes in prices. A yen appreciation tends to lower the price of imports relative to exports, pushing the trade balance higher. The real trade surplus, by contrast, excludes these valuation effects, assessing trade developments instead as the difference between the volume of goods shipped in and out of Japan. By this measure, the trade surplus did respond to the yen appreciation as one might expect: it fell 20 percent from 1990 to 1993 as more goods were imported into Japan and fewer goods were exported (Chart 6).

This article explains why the two measures of the Japanese trade surplus initially move in different directions when the yen appreciates. It also examines how the surplus is likely to behave under different exchange rate scenarios. The article's key conclusion is that the nominal surplus should fall significantly once the yen stabilizes. A further rise in the yen, however, would push the nominal balance still higher over the short term — while putting more downward pressure on the surplus when calculated in volume terms.

Recent developments

When measured in the yen value of the goods being traded, the nominal surplus jumped 75 percent from 1990 to 1993 as imports fell much more than exports.[1] When calculated in dollars, the nominal surplus advanced even more — 130 percent to $120 billion — because a given yen surplus is automatically converted into a higher dollar value whenever the yen appreciates.[2] Most of the $70 billion increase in the trade surplus during these three years stemmed from trade with the developing world. The trade balance with the United States rose by a relatively modest $12 billion, dropping from three-quarters of Japan's global surplus in 1990 to less than half in 1993.[3]

Although the slowdown in domestic activity in Japan affected the change in the trade surplus after 1990, the picture of a large trade surplus in 1993 would not be substantially altered if the Japanese economy had instead been operating at its potential level. The Japanese recession is estimated to have reduced imports by about $12 billion in 1993 from what they would have been if the economy were operating at its potential level.[4] This calculation indicates that the trade surplus would still have exceeded $100 billion in 1993, twice its 1990 level, even without the slowdown in the Japanese economy. A similar calculation for 1990 suggests that the trade surplus in that year was about $12 billion smaller because the Japanese economy was operating above its potential level.[5] Together, these estimates imply that changes in Japanese GDP relative to its potential level explain roughly a third of the $70 billion increase in the trade surplus from 1990 to 1993.

In contrast to the rise in the nominal trade surplus, the surplus in real terms dropped 20 percent from 1990 to 1993.[6] The rising yen helped push the real surplus down by making Japanese goods relatively more expensive on both domestic and world markets. As a consequence, the growth of exports moderated while the demand for imports rose despite the Japanese recession. An additional factor behind the slowdown in exports was weak economic activity in the major industrial countries.

A similar divergence between the real and nominal trade balances occurred after the yen's sharp rise in the mid-1980s. From 1985 to 1987, the yen appreciated 70 percent against the dollar. As in the more recent period, the nominal surplus rose in yen terms, increased much more in dollar terms, and declined in real terms.

The recent behavior of the real and nominal measures of the Japanese trade surplus raises two issues for policy-makers:

- The steep increase in Japan's nominal trade surplus may be troubling to the foreign exchange markets. In the mid-1980s, large nominal imbalances in the world were seen as one of the principal forces upsetting currency markets. The increase in the Japanese surplus marks the reappearance of large imbalances among the major industrial countries. In particular, Japan's $120 billion trade surplus in 1993 was $40 billion higher than its peak surplus in the 1980s.
- The decline in Japan's real trade surplus has favorable implications for employment and production in countries that trade with Japan. Output in these countries has been stimulated by the drop in the volume surplus to roughly half its 1985 record level.

The yen and import prices

The tendency for a yen appreciation to lower import prices governs the behavior of the nominal trade balances over the short term. The yen price of imported goods falls immediately when the yen rises against the dollar because most Japanese imports are denominated in dollars and therefore cost less in yen terms.[7] An appreciating yen will therefore lower the cost of imports, leading to a drop in nominal imports. Export prices may also fall as Japanese producers seek to offset the yen's rise to preserve their foreign sales, but the decline is limited by the producers' ability to cut costs or their willingness to accept lower profits. The recent difference in price behavior — with import prices in yen terms down 30 percent from 1990 to 1993 and export prices down less than 10 percent (Chart 7) — caused nominal imports to fall relative to exports, pushing the nominal surplus higher.[8]

The initial increase in the nominal surplus generated by a currency appreciation is eventually unwound as lower prices spur the demand for imports. Over the same period, export sales moderate because the stronger yen puts Japanese goods at a price disadvantage on world markets. More specifically, the boost to the nominal surplus from the drop in import prices is more than offset by a decline in the real balance as the demand for imports and exports responds to the change in relative prices.[9]

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[1] All data in this article are from the Japanese Tariff Association.

[2] When the yen's value changes, the behavior of imports and exports differs according to their currency denomination. For example, after the yen's rise from 1990 to 1993, imports remained roughly unchanged in dollar terms while they dropped sharply in yen terms.

[3] The bilateral balance with the United States, in yen terms, remained unchanged from 1990 to 1993.

[4] This estimate is based on a negative 4.0 percent gap between actual and potential GDP in 1993 and a 1.3 income elasticity for import demand. Further adjusting for weakness in some major industrial countries would narrow the difference between the actual and the cyclically adjusted trade surplus.

[5] The calculation assumes that the Japanese economy was operating roughly 4.0 percent above its potential level in 1990.

[6] The volume data, derived using unit value price indexes, reflect the number of items being shipped in and out of Japan. Some analysts question whether unit value indexes are the most appropriate price measure for calculating the real trade surplus because they do not take into account changes in the quality of traded goods.

The decline in the real surplus is closer to 50 percent if both 1990 and 1993 levels are adjusted for the deviation of Japan's output from its potential level.

[7] Food, oil, raw materials, and manufactured materials make up 85 percent of Japanese imports. These goods are usually priced in dollar terms on world markets.

[8] An alternative measure of export prices is available in Japanese wholesale price data. Based on a survey of prices for exported goods adjusted for quality changes, this index indicates more aggressive price cutting by Japanese exporters, particularly in 1991 and 1992, than is suggested by the unit value data.

[9] The nominal yen balance will fall back below its initial level if the demand for imports and exports responds sufficiently to changes in relative prices. The Marshall-Lerner condition specifies the relative price elasticities needed for a rising currency to lower the trade balance over time. Most empirical studies find that Japanese trade satisfies this condition.

The behavior of the nominal yen surplus, first rising and then eventually falling below its initial level, is known as the J-curve effect. This effect is illustrated in the lower panels of Chart 8. In Scenario I, a onetime yen appreciation raises the trade surplus (represented by the solid line) above the path it would have followed in the absence of an exchange rate change (dashed line). Over time, however, the balance falls below the level it would have maintained had the currency remained unchanged.

The Japanese trade surplus has yet to experience the full J-curve effect. It has not fallen back to its 1990 level because the rise in the yen was not a onetime jump. Instead, the yen appreciated 7 percent in 1991, 6 percent in 1992, and 14 percent in 1993, effectively creating a sequence of smaller J-curves (Scenario II). The trade surplus increased steadily after 1990 because the yen's ongoing appreciation kept the trade balance adjustment always on the initial upward segment of a succession of J-curves (represented by the solid line), preventing the surplus from reaching the downward segment (represented by dashed lines). If all of the yen's rise since 1990 had occurred in the first year, then the nominal yen balance would likely be significantly lower than it is today. The sequence of J-curves, however, has effectively delayed the date when the nominal balance reaches the downward segment of the J-curve.

Finally, note that the eventual decline in the nominal surplus in response to a yen appreciation will always be less than the decline in the real surplus. As explained above, a strengthening yen lowers import prices relative to export prices. The resulting change in relative prices offsets part of the decline in the real balance, causing the nominal surplus to be less affected by a rise in the yen than is the real surplus. Consequently, the yen has a relatively large impact on how Japanese trade affects the world's real economies and a relatively smaller impact on capital flow imbalances between countries.

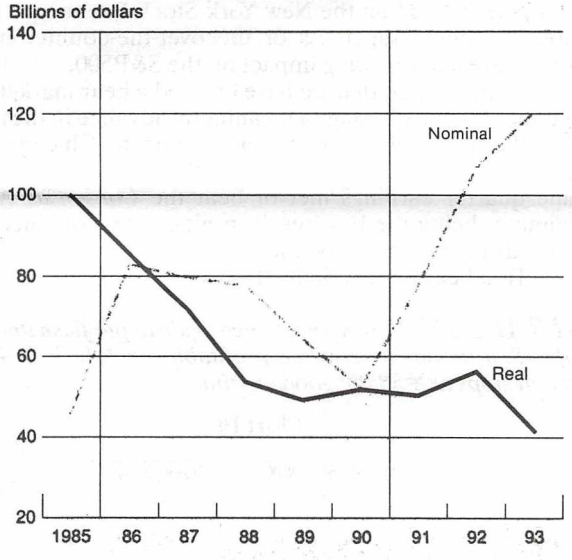
Conclusion

The rise in the yen since 1990 pushed the nominal Japanese trade surplus upward while reducing the real trade surplus. If the yen stabilizes, then the nominal balance is poised to decline in response to the past yen appreciation. A further rise in the yen, however, would likely force the nominal surplus even higher, delaying once again the downward adjustment in the merchandise trade surplus that eventually comes from a stronger yen.

Reprinted from the Federal Reserve Bank of New York Quarterly Review.

Chart 6

Japanese Merchandise Trade Surplus

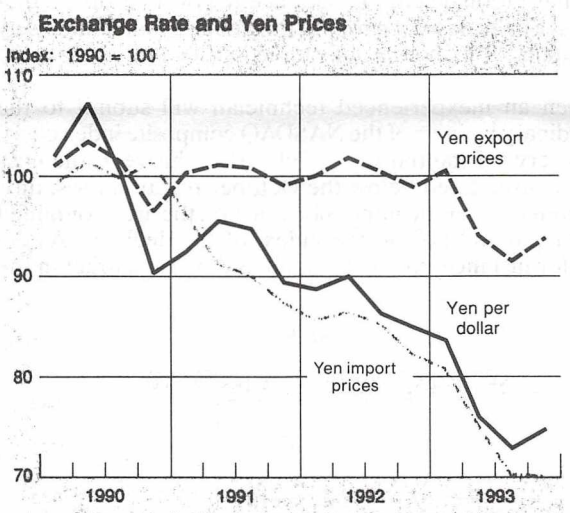


Source: Japanese Tariff Association, *Summary Report on Trade of Japan.*

Note: Real trade surplus is calculated using quantum indexes based on 1990 prices. Yen values are converted into dollars at the 1990 exchange rate.

Chart 7

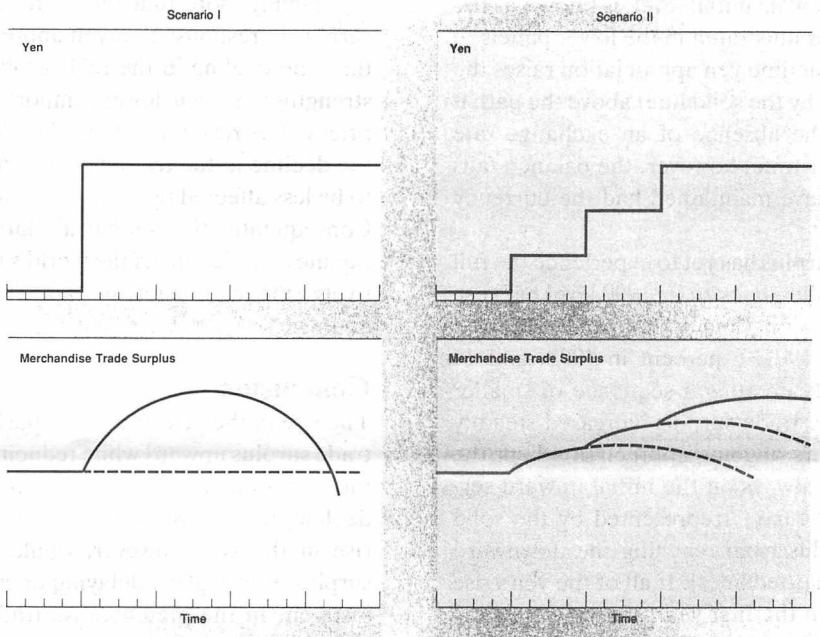
Exchange Rate and Yen Prices



Source: Japanese Tariff Association, *Summary Report on Trade of Japan.*

Note: Prices are unit value indexes in yen terms.

Chart 8 – Change in Trade Surplus under Two Yen Appreciation Scenarios



Note: Scenario I involves a single appreciation in the first period; scenario II, a sequence of appreciations.

STOCK INDEX FUTURES

'Tis a bear market

It is a truism to say that the US equity market is already contending with interest rates that are at least 100 basis points higher than the current rates (see our opening comments). And so the measly 2.84% dividend yield of the S&P 500 compares rather unfavorably with the 5.33% T-bill yield or 5.91% LIBOR rate implied in the December '94 futures. In fact, the yield gap is negative even if we were to use the S&P 500's earnings yield, currently at 5.01%.

What rationale can one adduce for owning stocks that yield less on the basis of *earnings* than riskless and immensely more liquid three-month obligations of the United States of America?

Even an inexperienced technician will submit to the extraordinary ugliness of the NASDAQ composite index chart. After a very substantial 12.5% fall earlier this year, the market has consolidated below the October reaction lows, unable to even recover the upper portion, i.e., the area contained between 750 and 800 on the index, of the decline. (As opposed, for instance, to the "bounciness" of the market in the first half of 1993, after suffering an almost similar decline). This bearish configuration carries a strong negative implication for the market as a whole, as aggressive growth mutual funds are heavily invested in NASDAQ issues. Redemptions will cause mutual funds to sell first their most liquid holdings, i.e., issues traded on the New York Stock Exchange. Therefore, continued sagginess of the over-the-counter market could have a devastating impact on the S&P500.

A further sign that we have entered a bear market is the market's inability to stage a meaningful advance in the face of scintillating earning reports; according to Chicago-based Zacks Investment Research, 71% of the companies recording June quarter earnings met or beat the *Consensus Analyst* estimate, being the best result in nine years, or since quarterly earnings began to be followed.

'Tis a bear market, indeed.

STRATEGY: *We are short once again as per flash update of July 18, after having covered profitably, on July 5, at 448.50. Retain stops at ¥58.00, good anytime.*

Chart 9

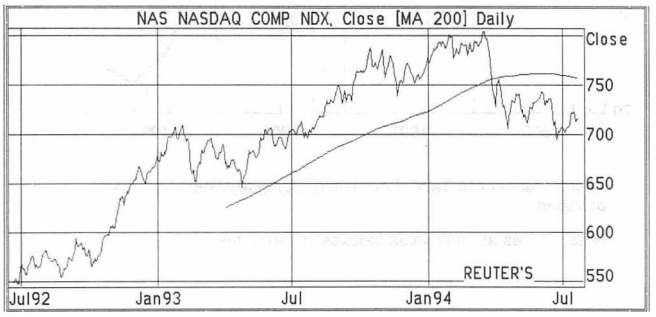


Chart 10

INTEREST RATE FUTURES

Still climbing; stay short

In line with our opening comments, we expect interest rates to continue rising until such time as the Fed regains initiative.

STRATEGY: *Remain short T-bonds; lower stops to 106.16, basis nearest contract month.*

Chart 11

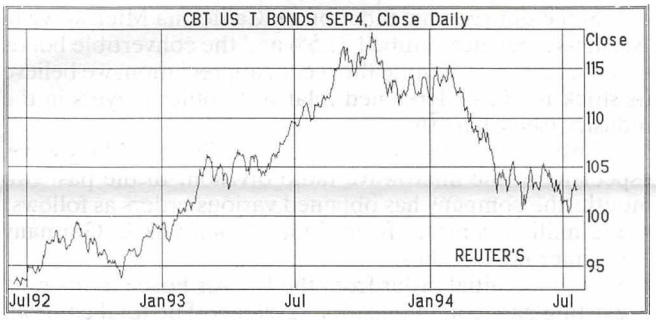
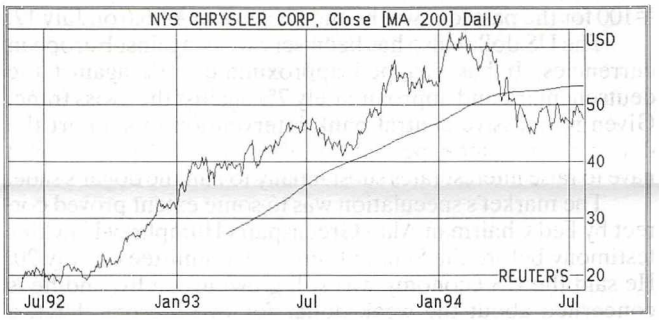


Chart 12



CRUDE OIL

Correction on the way; we're short

On July 14 , via our Hotline Update, we advised reentering the short side of the crude oil market.

Our rationale was based primarily on the shrinking refining margins. We reasoned that it would not be long before refiners cut back on their demand for crude, given their falling profit margins.

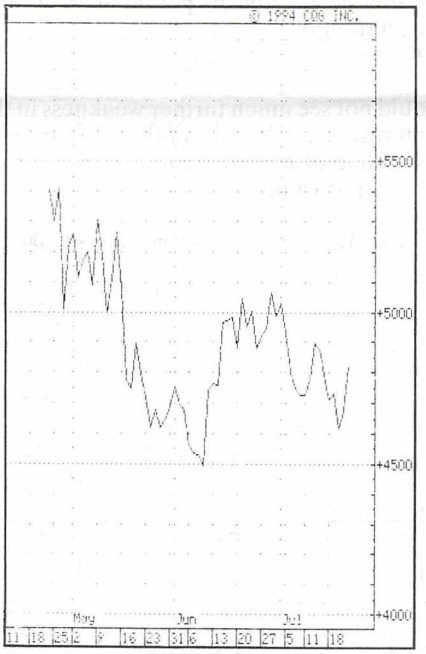
This position was taken in the face of upward revised demand projections for the fourth quarter of the year. The IEA estimated that world demand for oil will be 69.6 million barrels a day (mbd) in the fourth quarter, 300,000 barrels a day more than it had previously forecast, and 2.5 mbd above demand in the third quarter. The main reason was Asia's growing need for petroleum. The IEA said that OECD industry stocks at the end of the first quarter this year were adequate for 63 days of forward demand, down from 66 days a year earlier. It has also been taken in the face of a strike by Nigerian oil workers and a civil war in Yemen, which have reduced the flow of oil to world oil markets, and an imminent civil war in Algeria.

Even without a full resumption of Iraqi oil exports (and we expect a partial lifting of the embargo to accommodate Turkey), we believe that oil prices are due for a correction of at least $2 and perhaps $3 per barrel.

STRATEGY: *We are short with stops at 1905, basis January '95, good anytime.*

Chart 13

Chart 14 – Crack - Feb. 1995



Convertibles' value

The US bond market has been weak in the past two months. The yield on September US long bond futures almost reached 8% on July 11, before it retreated by 20 basis points in the next few days. The major driving force behind the weak bond market is the shaky US dollar. The yen/dollar exchange rate first fell below the ¥100 level on June 21. It has stayed below ¥100 for the past four weeks and hit a low of ¥96.6 on July 12.

The US dollar also has been very weak against European currencies. It has dropped approximately 9% against the deutschemark and approximately 7% against the Swiss franc. Given no massive central bank intervention to support the dollar, the market expected that the Federal Reserve would have to raise interest rates substantially to halt the dollar's slide.

The market's speculation was to some extent proved correct by Fed Chairman Alan Greenspan's Humphrey Hawkins testimony before the Senate Banking Committee on July 20. He said the US economy was still growing solidly, and he is concerned about the weak dollar for two reasons. First, a weak currency is itself inflationary. Second, it reflects the market's expectation of much higher future inflation in the US. Our interpretation of his testimony is that the Fed is ready to raise interest rates again to head off inflation that is expected to occur four to six quarters later (not in order to support the weak dollar).

We believe Greenspan's testimony has given no new information. In our previous issues we already pointed out that there would be two or three more interest rate hikes this year until the Fed funds rate hits 5%. Furthermore, the long-term yield should stabilize at around 8% by year end.

Owing to the weak bond market, the investment value of the convertible bonds in our portfolio has declined slightly (Chart 15). However, four of the six convertibles still trade below their investment value. The convertibles of Coeur D'Alene and California Microwave trade at a premium, since their stock prices are close to the conversion levels. We have put California Microwave in our managed bond accounts because of the strong upside potential in its equity (see the following writeup).

We believe the current prices of these convertibles have already reflected the expected Fed Funds hike to 5%. Therefore, we should not see much further weakness in their prices related to interest rates. We will continue to carefully monitor the credit standing of each debenture's issuer to determine these securities' fair value.

Chart 15 – Convertibles' investment value

Issuer	ATC	MASX	CDE	CMIC	DPT	GLYC
Credit rating	Caa	B3	CCC+	B	Ca	CCC
Recent price	$54.5	$96.0	$98.3	$100.5	$51.3	$52.3
Yield	15.8%	12.9%	7.7%	5.2%	19.6%	18.0%
Maturity	4/29/02	11/15/00	6/10/02	12/15/03	6/1/06	6/10/02
Estimated Investment Value	$67.1	$105.2	$71.5	$69.4	$65.0	$76.6
Over (below) investment value	(18.8%)	(8.7%)	37.4%	44.8%	(21.2%)	(31.8%)

ATC = Atari, MASX = Mastec (previously Burnup & Sims), CDE = Coeur D'Alene, CMIC = California Microwave, DPT = Datapoint, GLYC = Glycomed

California Microwave Inc.

Security: 5¼% convertible subordinated debentures
Maturity: December 15, 2003
Recent price: $100
Yield: 5.25%
Conversion price: $28.4375 per share
Recent stock price: $24 per share

Since our recommendation on California Microwave in April, its stock has climbed 31.5% and the convertible bonds by 11%. However, despite the recent appreciation, we believe its stock is still undervalued relative to other players in the industry (see Chart 16).

Business continues to thrive at California Microwave, especially in the microwave radio division. In the past two months the company has obtained various orders as follows:

- $82 million contract from E-plus Mobilfunk in Germany for microwave radios.
- $4 million initial order from the US Air Force to upgrade existing data communications systems. The total contract will be up to $24 million.
- multi-million dollar order (exact figure not disclosed) from Northern Telecom Europe for digital radios.
- $3 million initial order from Banco Nacional de Mexico (Banamex) for digital radios. It is the first order of a long-term program to expand Banamex's telecommunications network.

These additional orders will add to the backlog of California Microwave and keep the projected revenue and EPS growth on track. We maintain our EPS estimates of $1.13 for fiscal 1994 and $1.39 for fiscal 1995. Our target stock price in 12 months is between $30 and $32, implying a P/E of 21.6 to 23.

The convertible bonds are currently trading with a 18.5% premium over their conversion value. We believe the premium will shrink to approximately 10% when the stock price climbs to our target range. In other words, our 12-month target price of the convertible bonds is in the range of $116 to $124. With a 5.25% coupon, the potential one-year return on the converitbles is 21% to 29%. The bonds are not callable until January 1997.

The solid fundamentals of the company have increased our confidence that the target price will be reached. Therefore, we have given the convertible bonds a 5% allocation in our managed bond accounts, and Friedberg Mercantile Group will be making a continuous market in them.

Chart 16 – Comparative Valuation - Microwave Companies

Company	Market Cap ($ million)	LTM* P/E	Expected P/E	LTM* Price to Sales	Price to Book	Debt to Market Cap
California Microwave	**279**	**21.17**	**16.90**	**0.87**	**2.14**	**0.46**
Scientific Atlanta	1,290	36.05	23.30	1.74	3.45	0.16
Andrew Corp.	1,008	32.06	26.86	2.04	4.27	0.14
Digital Microwave	183	Neg	16.57	1.58	7.22	0.27
Motorola	27,434	22.74	21.17	1.40	4.06	0.27

More on Glycomed Inc.

Security: 7.5% convertible subordinated debentures
Maturity: January 1, 2003
Recent price: $53
Yield: 18.8%
Recent stock price: $2.5
Conversion price: $14

Glycomed has announced a restructuring plan to lay off 30 employees and focus its research on cell adhesion inhibitors for the treatment of inflammatory diseases and cancer. At the same time, its CEO, Dr. Alan Timms, and CFO resigned. Dr. Alan Timms will remain as a director and consultant to the company.

The restructuring is expected to reduce the annual cash burn to $10 million from the current $16 million. The president, Brian Atwood, has become the CEO. The restructuring is necessary for Glycomed's long-term survival as the company has to make optimal use of its resources to commercialize the products currently in the pipeline. Progress in the most advanced product, Galardin MPI, is about six to nine months later than scheduled. Glycomed has completed the patient enrolment for the stage III clinical trial and the results are expected to be available at the end of 1994. It should be able to file a new drug application in the second quarter of 1995.

Glycomed also has entered into a collaboration with Sankyo Co. Ltd., the second-largest pharmaceutical firm in Japan. Focused on anticancer agents, Sankyo has annual sales of $4 billion and a market capitalization of $9 billion. Under the agreement, Sankyo will make a $1.5 million equity investment in Glycomed and provide $9 million funding over three years. In addition, Glycomed will receive $5 million for each compound developed. In return, Sankyo is granted exclusive marketing rights to Glycomed's cell adhesion products in the Far East.

The deal is definitely good for Glycomed. Not only does it reduce its future financing requirements, but it also shows Sankyo's confidence in Glycomed's research capabilities. Giving up the marketing rights to Sankyo does not change our valuation, since potential sales outside the US have not been taken into account.

The change in management may sound disturbing to investors. However, it is in fact a mildly bullish signal as, with the old management having left, the board now should find it easier to seek merger partners or buyers. With $70 million unrestricted cash and the stock trading at below book value, the company is unrealistically cheap. Wait for a takeover in the range of $4 to $7 per share. The bonds should also rally at the same time.

Update on TWA

Security: Senior Secured Bonds
Coupon: 10%
Maturity: Nov. 3, 1998
Recently price: $54.5
Yield: 28.5%

The price of TWA's 10% bonds recently slid to the mid $50s from the high $60s. Should investors continue to hold? We want to reemphasize our strong hold recommendation, which is based on strong asset coverage.

Standard & Poor's downgraded the 10% bonds to CCC from CCC+ on June 30, citing continuous fare discounting and potential liquidity problems. The downgrade has been used as an excuse to sell. We do not believe it should affect the fundamental valuation for the following reasons: 1) the downgrade is reactive rather than proactive; 2) whether it is CCC or CCC+, it is a junk category, and the most important consideration for these securities is asset coverage, which we estimated at 115% to 120% of the bonds' face value.

TWA is working in the right direction by cutting cost aggressively. Robin Wilson, the former vice chairman, resigned three weeks ago. His departure signals the complete takeover by the new management, led by Donald Craib, who has taken a fresh look at the entire airline and decided to bring TWA's cost structure in line with its competitors. Since the competition from low-cost short-haul operators has put tremendous pressure on prices, we believe the only way for an airline to survive is to have a competitive cost structure.

Craib stated that the target of the cost-cutting program is to save an annual $135 million, and layoffs seemed inevitable. The target is equivalent to approximately 10% of TWA's operating costs excluding fuel, salaries, depreciation and aircraft rentals. TWA recently decided to discontinue services by TransWorld Express to 12 cities and, therefore, to eliminate 475 jobs. With other streamlining efforts, about 60% to 70% of the target savings have been achieved to date.

TWA has set up a special task force that includes both management and labor representatives to review the airline's operations in order to find cost-saving means. The involvement of labor is very important, as it means any decisions by the task force should also be acceptable to the unions. Consequently, there will be minimal negative impact on employee morale and productivity.

We estimated TWA's cash position at the end of June to be $100 million to $110 million. With the current cost cutting efforts, that should be able to carry the airline through the winter season. The major concern on the market (also S&P's concern) now is whether TWA can refinance the $200 million Icahn facility ($190 million currently outstanding) coming due on January 8, 1995.

The Icahn facility is divided into two parts. Part one is a $115 million facility secured by TWA's accounts receivables, which had a book value of $329 million at the end of March 1994. Part two is an asset-based facility of $85 million, which is secured by 35 aircrafts and 41 spare aircraft engines. According to the appraisal of Avmark Inc., the security has a market value of approximately $245 million. In other words, the two facilities together are presently 302% collateralized. Therefore, even if Icahn refuses to refinance, it is very likely that TWA can secure financing somewhere else, maybe even at better terms.

Furthermore, we believe Icahn has every incentive to renew the facilities. The reason is that if TWA goes into bankruptcy, Icahn will be personally liable to the Pension Benefit Guarantee Corp. for up to $30 million each year for the next eight years. The potential amount of the liability may exceed the entire facility.

In summary, we believe TWA should remain solvent in the next 12 months. Its medium-term outlook (12 to 24 months) depends on whether 1) cost cutting efforts are successful, 2) existing assets can be used more effectively to obtain additional financing, 3) summer traffic will meet expectations, and 4) oil price will come down in time to give them a windfall gain (see our comments on oil in this issue).

Finally, the long-term prospects rest upon whether TWA can enter into a merger (sale) or strategic alliance with a financially strong partner, which we believe Salomon Brothers is diligently working on.

– Edison Lee

TURKEY

For speculators: superior real rates

A long series of public sector deficits that culminated with a PSBR of 17.5% of GNP in 1993 were the proximate cause of a virulent inflationary episode, an alarming current account deficit, and a collapsing currency. The lira fell to 41,000/US$ in April of this year from 3,000/US$ in early 1991, not before more than half of the central bank foreign exchange reserves were depleted, and forcing up interest rates to more than 600% per annum.

On April 5 the government of Prime Minister Tansu Ciller unveiled a tough economic package that included a 50% cut in the public sector borrowing requirements to 9% of GNP through increased taxes, spending cuts, speedier privatization, and closures of state enterprises. On July 8 the IMF board approved a 14-month standby for Turkey. The facility will allow a drawdown totalling $742 million in stages starting this month, provided the Turkish government underpins the radical cuts in the public deficit with a monetary squeeze to bring down inflation to 20% by mid-1995, compared with an annual rate of 118% in the 12 months to the end of June. The government's fiscal balance, excluding interest charges, is to shift from a deficit of 6.1% of GNP in 1993 to a surplus of 4% this year and 8% in 1995. The program assumes a 15% real wage cut across the economy.

There are enormous political difficulties in implementing this program, not the least of which is to contend with very powerful state industries, which in the past financed themselves by not paying tax to the central government or not contributing to the social security system. At the same time, the public sector unions have already staged protest against being forced to accept wage indexation based on *future* inflation. Finally, political opposition and bureaucratic paralysis have been delaying the much-needed privatization efforts, although the government insists that it will carry them out.

The measures taken thus far have already borne some fruit, as the current account balance in April swung into surplus aided by a sharp narrowing of the trade gap (see Chart 17). Industrial production in May plunged 13.6% below a year ago, under the burden of high interest rates and a doubling in certain administrative prices under the stabilization program. Real GNP is expected to fall at least 2% this year and possibly more, the first such fall since the stabilization efforts of 1980.

The key to this stabilization program is the fiscal retrenchment and the breakup and/or privatization of the state enterprise fiefdoms. Nothing short of this will remedy the country's finances. It is still doubtful that the government of Tansu Ciller has the political will and clout to implement this fiscal retrenchment. Furthermore, stabilization programs tend to achieve their objective in the short run but, unless followed by liberal pro-growth policies, they tend to be followed by a second and third program.

The currency is undervalued in real terms, although up more than 20% from the March/April lows due to the recovery in the nominal rate of exchange — to 31,000/US$ from 41,000/US$ and the sizeable CPI increases in the last three months. At June1994, the real effective exchange rate as calculated by JP Morgan stood at 86.6 with 1990 = 100.

Three-month and six-month Treasury bills are regularly tendered by the government with yields this past week in the 83% to 100% annual rate range. These yields naturally translate into much higher returns because of the compounding effects (every three or six months). Should this stabilization program be successful — which we believe in the short run will be so — monthly inflation numbers should begin to decrease towards 2% per month by the middle of 1995. The potential for a substantial pickup in returns, given monthly yields in excess of 8% is quite evident.

While it is true that another currency rout as occurred in the first quarter of this year could wipe out a lot of the gains (and even produce substantial losses), it is also true that in that case the government will have nowhere to turn and will be forced, in the subsequent auctions, to offer extremely attractive real rates.

In sum, a successful stabilization program can provide us with very juicy real returns out to June/September 1995. A-not-so-successful program, on the other hand, will do the same but with a considerable delay, while a failed program may keep us invested in the Turkish money market for a number of years trying out our patience and fortitude.

STRATEGY: *We recommend to our managed accounts an exposure to Turkish Treasury bills not to exceed 10% of their portfolios.*

Chart 17

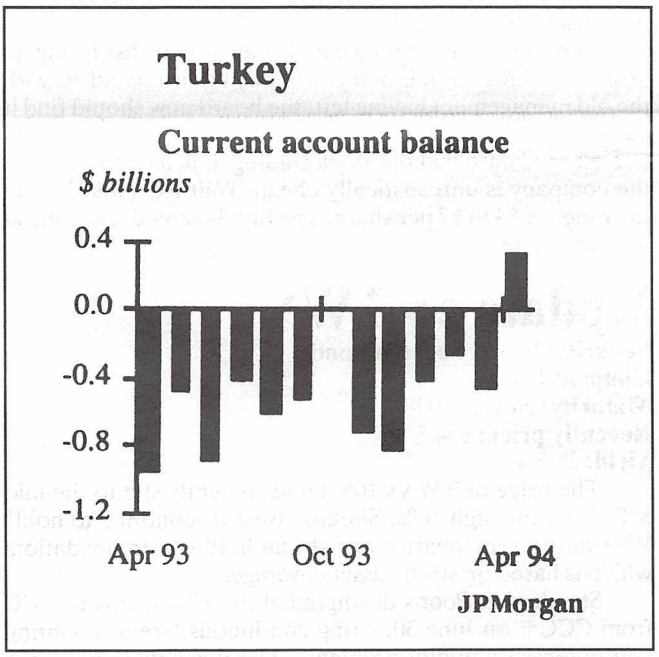


Chart 18
Breakeven exchange rates for US$-based investor

This analysis shows a "snapshot" of the relationship between interest rate differentials and rates of exchange. The breakeven rate measures how far the foreign currency has to devalue (for NZ$, A$, DM, DKr, BP, FFr, ECU, CD, SAR, ITL, ARG and FIN) or revalue for SF, JY, before the interest rate advantage/disadvantage is overcome by currency depreciation/appreciation. **Rates as of July 22, 1994.**

	U.S. $	NEW ZEALAND	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	5.52%													Finland '95 yields 7.73% (5.3657 FIM/US)
2 year	6.10%		VEB 7% '96 yields 16.15% (1.907 US/DM)		World Bk '96 yields 2.91% (92.71 US/JY)	Denmark '96 yields 6.93% (6.337 US/DKr)	Sweden '96 yields 6.52% (1.5204 BP/US)	Credit Lyon '96 yields 6.57% (5.492 US/FFr)			ESCOM '96 yields 12.22% (.1957 SAR/US)	NIB '96 yields 10.02% (1.70 ITL/US)		
3 year	6.42%									R.B.C. '97 yields 8.49% (1.4604 Cdn/US)				
4 year	6.63%		Argentina '98 yields 8.16% (1.6845 US/DM)											
5 year	6.90%	Tranzrail '99 yields 9.86% (.5276 NZ/US)		G.E. '98 yields 5.11% (1.231 US/SF)										
6 year	6.98%								UK '01 yields 7.60% (1.1605 US/ECU)					
8 year	7.04%												BIC V '01 yields 15.97% (1.896 US/ARG)	
9 year	7.18%													
Spot Exchange Rate	–	.6048	1.5912	1.34	98.55	6.239	1.5325	5.444	1.2015	1.3784	.2189	1.5815	.9988	5.2556

*For example, since a US$-based investor would receive 296 basis points (986-690) by holding the TranzRail NZ$ bond, the NZ/US can depreciate to .5276 from the present spot exchange rate of .6048 over the next 5 years for the NZ 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.

HOTLINE UPDATE

Tuesdsay, June 21:
There are no new updates or recommendations.

Friday, June 24:
There are no new recommendations; as well, there were no recommendations or flash updates this previous week.

Tuesday, June 28:
There are no new updates or recommendations.

Friday, July 1:
There are no new updates or recommendations, for this previous week.

Flash update, Tuesday, July 5, 11:00 am:
Cover all short S&P futures positions at the market. September is currently trading at 448.50.

Tuesday, July 5:
We have one new recommendation. We are presently long Swiss, short yen on a spread basis; raise your stop basis the DM/JY cross to 6160 from 5990, New York closing time. We repeat this morning's flash update of 11:00 am to cover short S&P futures at the market, then trading at 448.50.

Flash update, Thursday, July 7, 10:30 am:
1. Liquidate long soymeal positions at the market.
2. Buy October sugar positions at the market. October sugar opened at 1140.

Friday, July 8:
There are no new recommendations for today. Following is a recap of this week's recommendations:

Tuesday July 5, via flash update at 11:00 am, cover all short S&P futures positions at the market; S&P was then trading at 448.50.

Also, one new recommendation for Tuesday July 5: We are presently long Swiss, short yen on a spread basis. Raise your stops basis the DM/JY cross to 6160 from 5990, NY closing time.

On Thursday July 7, via flash update at 11:00 am, we liquidated long soymeal positions at market, and advised to buy October sugar positions at the market; October sugar opened at 1140.

Tuesday, July 12:
There are no new recommendations.

Flash update, Thursday, July 14, 2:30 pm:
Sell January crude oil at the market, place stops at 1905, good anytime.

Friday, July 15:
There are no new recommendations.

This is a recap of this week's flash update. On Thursday, July 14, at 2:30 pm via flash update, we advised to sell January crude oil at the market; place stops at 1905, good anytime. January crude oil was trading at 1861.

Flash update, Monday, July 18, 9:52 am:
Sell September S&P at the market, currently trading at 454.00, risking 458.00, good anytime.

Tuesday, July 19:
There are no new recommendations for today.

This is a recap of the flash for Monday, July 18, at 9:52 am: Sell September S&P at the market, then trading at 454.00, risking 458.00, good anytime.

Friday, July 22:
This is a complete summary since our last market letter, dated June 20, of all liquidations of open positions and new recommendations that remain outstanding.
1. On Tuesday, July 5, via flash update, we advised you to cover short September S&P at the market, then trading at 448.50.
2. On Tuesday, July 5, we recommended that you raise stops on the Swiss/yen spreads to .6160 basis the DM/yen cross, good at the New York closing time.
3. On Thursday, July 7, via flash update, we advised the liquidation of long soymeal positions; December soymeal opened at 179.00. We also recommended the purchase of October sugar at the market; October sugar opened at 11.40.
4. On Thursday, July 14, via flash update, we advised the sale of January crude oil, then trading at 1861; stops were placed at 1905, good anytime.
5. On Monday, July 18, via flash update, we advised the sale of September S&P at the market, then trading at 454.00; stops were placed at 458.00, good anytime.

Chart 19 – Recommended current portfolio allocations

1. Gold/Yen Bond	20%	4. New Zealand Gov't	20%	7. Turkish Lira T-Bills	10%
2. Tranz Rail NZ$	5%	5. Bk. For. Eco. DM	2½%	8. California Microwave	5%
3. CIL NZ$	5%	6. FRB/BIC V	15%	9. U.K. FRN	17½%

Chart 20 – FOREIGN CURRENCY BONDS

DATE: July 21, 1994 — *We offer the following Bonds subject to change without prior notice: Minimum US $4000 (CDN $6000)*

ISSUER / COUPON / MATURITY DATE	BID	OFFER	YTM	CURR. COUPON	NEXT INTEREST PAYMENT DATE
DEUTSCHE MARK DENOMINATED BONDS					
Bank of Nova Scotia 5 5/8% 7/5/96 RRSP	99.85	100.7	5.19		May-07
World Bank 5 7/8% 4/02/97 RRSP	101.4	102.25	4.89		Feb-04
World Bank 9% 13/11/00 RRSP	111.9	112.75	6.46		Nov-13
Kingdom of Denmark 6 1/8% 15/04/98	99.5	-	-		Apr-15
Argentina 8% 5/10/98	98.6	99.45	8.15		Oct-05
Bk. Foreign Eco. Affairs 7% 29/3/96	86.5	87.35	16.15		Mar-29
Kgdm. of Spain (Floating) 29/6/02 (semi)	99.14	99.44		4.9375	Dec-29
FINNISH MARKKA DENOMINATED BONDS					
Rep. of Finland 11% 15/6/95	101.75	102.6	7.74		Jun-15
ITALIAN LIRA DENOMINATED BONDS					
Nordic Inves. Bk 12 3/8% 19/04/96	102.6	103.45	10.02		Apr-19
General Electric 11 1/2% 7/02/95	100.3	101.15	8.73		Feb-07
SWISS FRANC DENOMINATED BONDS					
General Electric 4 3/4% 2/7/98	97.9	98.75	5.11		Jul-02
DANISH KRONE DENOMINATED BONDS					
Kgdm. of Denmark 9% 15/11/96	103.25	104.1	6.98		Nov-15
ECU DENOMINATED BONDS					
United Kingdom 9 1/8% 21/02/01	106.65	107.5	7.62		Feb-21
BRITISH POUND DENOMINATED BONDS					
Kdgm. of Sweden 8 3/4% 29/5/96	102.50	103.70	6.52		May-29
FRENCH FRANC DENOMINATED BONDS					
Credit Lyonnaise 9 1/2% 23/12/96	105.4	106.25	6.57		Dec-23
JAPANESE YEN DENOMINATED BONDS					
World Bank 5 3/4% 7/8/96 RRSP	104.65	105.5	2.91		Aug-07
CANADIAN DOLLAR DENOMINATED BONDS					
Ontario Hydro 10 7/8% 8/01/96 (semi)	103	104.5	7.53		Jan-08
Eksportfinans 7 3/4% 5/11/97	96.4	-	-		Nov-05
Royal Bank of Canada 9 1/8% 7/1/97	99.75	101.25	8.49		Jan-07
SOUTH AFRICAN RAND DENOMINATED BONDS					
ESCOM 12% 1/5/96 (semi)	98.85	99.7	12.15		Nov-01
AUSTRALIAN DOLLAR DENOMINATED BONDS					
Commonwealth Bk. of Australia 9 3/4% 15/5/96	101.50	-	-		May-15
NEW ZEALAND DOLLAR DENOMINATED BONDS					
New Zealand Gov't 10% 15/7/97 (semi)	105.55	106.4	7.55		Jan-15
Fletcher Challenge 10.75% 15/12/97 (semi)	102.35	103.20	9.61		Dec-15
Fletcher Challenge 10.15% 30/11/98 (semi)	100.8	101.65	9.67		Nov-30
Corporate Investment Ltd. 13 1/2% 19/6/95 (semi)	91.25	-	-		Dec-19
Tranz Rail Ltd. 10% 15/10/99 (semi)	99.55	100.4	9.89		Oct-15
DB Group 7% 30/6/96 (semi) matures @ 85	87.35	88.2	5.27		Dec-30
ARGENTINEAN PESO DENOMINATED BONDS					
BIC V Fixed/Floating 1/5/2001 Callable in full on every interest date	76.65	77.5	15.97		4th day of mth.
U.S. DOLLAR DENOMINATED FIXED CONV. BONDS					
Datapoint Corp. 8 7/8% 1/6/06 CV@18.11p/sh (semi)	44.25	46.25	21.59		Dec-01
Burnup & Sims 12% 15/11/00 CV@16.79 p/sh (semi)	94	96	12.94		Nov-15
Atari Corp. 5 1/4% 29/4/02 CV@16.31 p/sh	53.25	54.5	15.82		Apr-29
Coeur D'Alene 6% 10/6/02 CV@ 26.00 p/sh	88.25	90.25	7.69		Jun-10
Glycomed 7 1/2% 1/1/03 CV@14.06 (semi)	52.25	-	-		Jul-01
California Microwave 5 1/4% 15/12/03 CV@28.44 p/sh (semi)	98.5	100.5	5.18		Dec-15
U.S. DOLLAR DENOMINATED FIXED RATE BONDS					
Farm Credit Corp 7 3/4% 10/06/96 RRSP	102.75	103.6	5.65		Jun-10
T.W.A. 10% 3/11/98 (semi)	53.65	54.5	29.42		Aug-01
U.S. DOLLAR DENOMINATED FLOATING RATE NOTES					
Kgdm. of Denmark 25/3/97 (Gold call, JY put),(semi)	98.5	99.5		3.02	Sep-25
United Kgdm. 30/9/96 3 mo.LIBID-1/8 (qtly),callable @100	99.7	100		4.5	Sep-30
Bocon 1/4/01 (30 day LIBOR) starts accruing May 1,1997	78.45	79.3	13.45		May-01-97
Argentina: Series L:FRB 31/3/05, 6 mo. LIBOR+13/16 (semi)	72.375	73.125	11.51	5	Sep-30

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

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