

# FRIEDBERG'S

## COMMODITY & CURRENCY COMMENTS

Friedberg Commodity Management Inc.



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### Why US interest rates are heading higher

For many months and at regular intervals, we've posited a case for higher interest rates. And higher, indeed, they have moved. Lest we become too complacent, it behooves us to review the evidence.

Our bullish case for rates was primarily based on our belief that interest rates were lowered *artificially* by the Fed in its attempt to revive the economy and reliquify the near-bankrupt banking system. This series of highly discretionary policy actions, we contend, had no basis in reality: The Fed had no way of knowing what the "right" rate of interest was simply because it did not, and does not, know how to quantify the demand for money. Even worse, neither the Fed nor any living economist really knows what money is, let alone be able to quantify the "appropriate" supply of money. In fine-tuning — manipulating — interest rates, we suggested that the Fed was navigating in stormy seas without a compass. And the captain of the boat was blind.

The market did not wholly swallow the Fed's game plan. It is true that the Fed aided by multi-billion dollar speculative manoeuvres, called "carries" in the trade, succeeded in forcing the yield curve down so that, by late 1993, even 30-year government paper was trading below 6%. The *slope* of the curve, however, steepened to become the most positively sloped yield curve in the past 75 years (see chart and comments in our May 23, 1994 issue), a clear vote of no confidence.

What has happened since the first of the year? The Fed has rushed to make up for this excessive ease. By the end of the first half of the year Fed funds had increased 1¼ percentage points from their nadir. In typical central bank lingo, the Fed was able to announce that it had "substantially complete(d) the removal of the degree of monetary accommodation that prevailed throughout 1993."

But it still knows not how far it has strayed nor where it is heading to. In early February, 90-day Eurodollar deposits were trading 100-115 basis points below where the market thought they ought to be nine to 12 months out. Nine months later, and at least three tightening episodes later, 90-day Eurodollar deposits remain 150-180 basis points below where the market thinks rates ought to stand nine to 12 months out.

The market remains sceptical, and for good reason. How does the Fed know how much "monetary accommodation" to remove? The amount was recorded during 1993? 1992? What about 1989-93 or 1983-93? And what does the

Fed mean by that expression "remove"? It *clearly* does not mean *reduce* the "money stock" to the level existing at some predetermined date. Does the Fed really *know* if the monetary ease of the past five and 10 years (to follow the evidence of the yield curve) can be *removed* by decelerating? Or does it merely *believe* that it could do that because logically — it will argue — prices have already absorbed the prior monetary accommodation.

But this may or may not be true: Benign movements in velocity, as happened during much of the '80s, may change course abruptly, as Mr. Greenspan admitted had taken place in more recent years, simply because the *accumulated* level of nominal balances has finally come to be perceived as excessive. The sins of the previous generation are only being revisited now. One need not be a mathematical genius to note that monetary balances and highly liquid financial assets — in relation to commodities — have exploded over the past 15 years. Once "triggered," the price of many commodities will double and triple.

In short, the absence of an anchor in a fiat money system will doom the attempts of any central bank to eradicate

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Contributions by Albert D. Friedberg, Edison Lee, and David B. Rothberg.

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

inflation and the boom-bust cycles of financial assets.

So much for theory.

In practice, Fed actions have been as good as ineffectual. The Federal Open Market Committee's directive to "increase somewhat the existing degree of pressure on reserve positions," a decision taken at the meeting held on May 17, 1994, and most certainly repeated at the most recent August 16 meeting, failed to produce the desired effect. Adjusted reserves *increased* at an annualized 4.1% from May 25 to August 3 in contrast to a -0.6% annual rate of change recorded for the prior two months. Moreover, the adjusted monetary base has grown at an 8% annual rate in the eight weeks ended August 31, no great deceleration from the 8.7% annual rate of change recorded from the past year. Where is the "increase in the existing degree of pressure on reserve positions"?

As we suggested in previous issues, the shift from demand deposits to time deposits caused by the Fed-induced rise in rates tends to free banking reserves, given the lack of reserve requirements in the latter category of deposits. Banks will continue to be able to expand their balance sheets even if the Fed were successful in applying the appropriate degree of pressure on reserve positions. Total bank credit continues to expand at a healthy clip, even giving signs of accelerating. (See Chart 1). Of course, most of the increase in bank credit

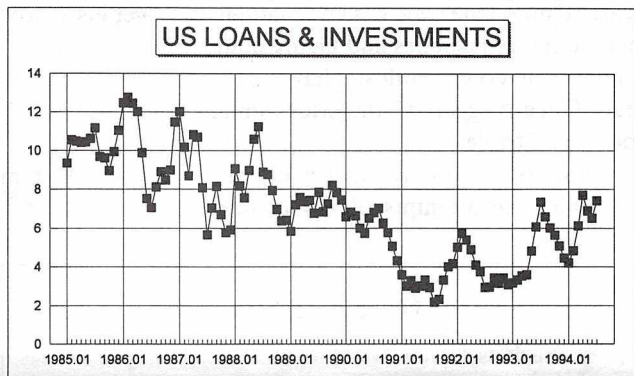
is in the category of loans; at this point the banks are barely adding to their investment portfolio. Very soon commercial banks will turn to sellers of securities to accommodate rising loan demand. It is then that the rise in interest rates will begin in earnest.

Interestingly, speculators lulled by the temptations of easy money (pun intended) have remained obstinately long government securities financed via repos and/or other short-term instruments (see Chart 3). Will this massive overhang of securities, speculatively funded, hit the market at about the same time as banks begin to disgorge themselves as per our earlier comment of their \$960 billion total investment portfolio? Who will be the buyers of these securities? The public has lost its appetite as indicated by the continuous outflow of money from bond funds. Nor do foreigners seem interested in securities denominated in a depreciating currency.

Of course we do not imply that *nobody* will bid for these securities. There always is *somebody*. But that somebody, we suggest, will want to be compensated adequately for taking the risk of buying long-term securities in a fiat money world. Who can guess what that rate will be?

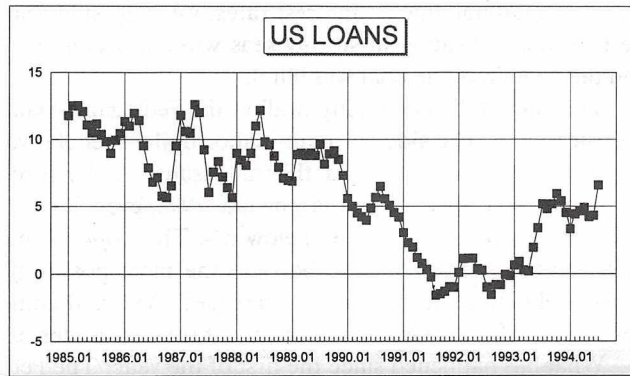
**STRATEGY:** *You have been short T-bonds since Nov. 21, 1993. Remain short; we are in for a long haul.*

Chart 1



6-Month Compounded Annual Rates of Change

Chart 2



6-Month Compounded Annual Rates of Change

Chart 3

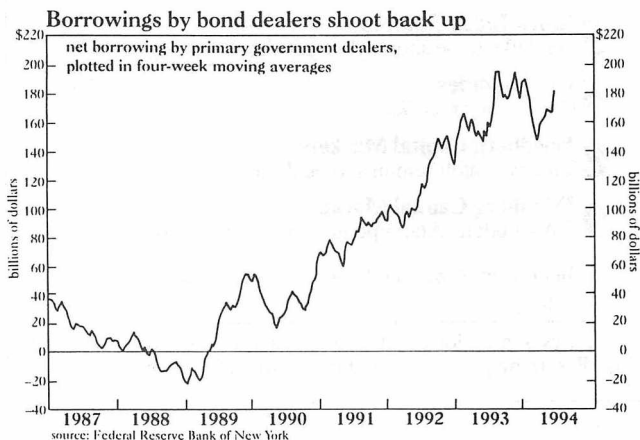
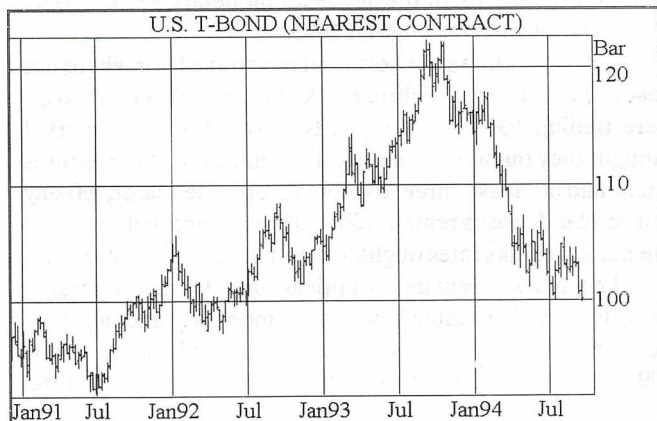


Chart 3

Chart 4



**PRECIOUS METALS**

# Higher prices on the way

We found, in what is mostly a boring and almost useless (from a predictive point of view) document, *Goldfields Gold 1994* report, two worthwhile pieces of information: Central bank sales fell to 36 tonnes from a 275 tonne disposal in the first half of 1993, a "natural" result of the perceptual change taking place in the minds of the bureaucrats handling central bank assets. The bull market is no flash in the pan (as it appeared in early 1993). It has staying power and, possibly, potential. Therefore, sales are to be reduced. Canada (where the process of demonetizing gold is almost complete), it should be noted, is the main exception.

Secondly, and even more interestingly, supplies of gold were reduced by the continued fall in gold loan activities by producers. These loans accounted for 217 tonnes of gold being supplied to the spot market in the first half of last year against a zero figure this year due to the continued repayment

of loans and increased use of options by producers. This is a dramatic example of the speed with which non-mineable supplies can disappear.

As prices begin to rise above the now formidable \$410/oz. barrier, the market will be faced with the classic case of "leads and lags" so prevalent in foreign exchange markets that anticipate a devaluation: Mineable supplies will fall, a result of producer speculation and labor unrest, non-mineable supplies will evaporate, investment (speculative) demand will enter the picture, and buy-back of producer hedges will violently upset the "delicate balance."

**STRATEGY:** *You are long gold, silver, and platinum with stops at 379, 525, and 403, basis close only, respectively. Expect dramatically higher prices.*

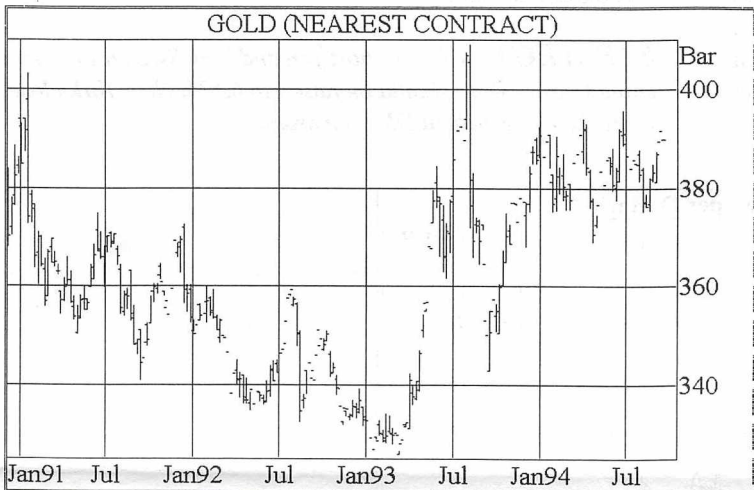
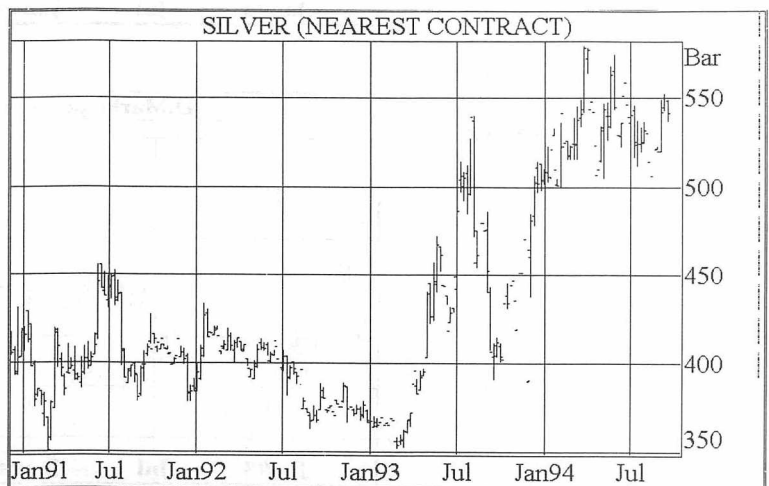


Chart 5

Chart 6



**CURRENCIES**

# Yen's depreciation inevitable

A marked change in market rationale has occurred over the past four to eight weeks. Signs of overheating of the US economy, formerly thought to induce a rise in interest rates and thus a bullish event for the dollar, have become a bearish piece of news. No doubt, the market has begun to focus on real rates of interest. Given the Fed's poor anti-inflation credentials, the market fears the emergence of negative real returns. It is here where credibility counts for so much.

The Swiss, with a decent history of price stability, can enjoy low long-term interest rates and a strong currency. The Germans, somewhere in between, have managed to mar the record by their extraordinarily inconsistent monetary policy of the past four years and thus suffer from a weak bond market. And yet their currency is preferred to the dollar, which is now paying the price of an anchorless system. (See our lead article).

A combination of a very hot summer and a minor tax cut has lifted Japanese spirits and produced an extraordinary 23.6% rise in imports during March, which in turn produced an unexpectedly large 18.8% fall in the August trade surplus. If the economy did in fact turn around, the trade surplus will shrink further, setting the stage for more significant trade-weighted depreciation of the yen.

The adjustment process is almost complete. Consumer debt burdens have been lightened considerably and corporate boardrooms have become much more focussed on productivity gains, profitability, and healthier balance sheets. If the Ministry of Finance would abandon its stock-price support fixation and give the green light for firms to issue new equity, corporate Japan could fully recover in a short time.

It is inevitable that the Japanese yen will depreciate, although it may have to wait until Japan's high rate of domestic savings falls. Tax cuts, cheaper real estate, more competition in the consumer sector (witness the extraordinary growth of discount stores at the expense of the more traditional department stores), and better economic visibility will all tend to reduce domestic savings, the counterpart of the enormous current account surplus. Given the temporary weakness of the US dollar (eventually we hope the Fed will learn how to do it), we continue to favor a short yen/long Swiss franc position.

**STRATEGY:** *You are short yen and long Swiss francs on a spread basis. Stops should be raised to 62.75, New York close, basis the more critical DM/yen cross.*

Chart 7

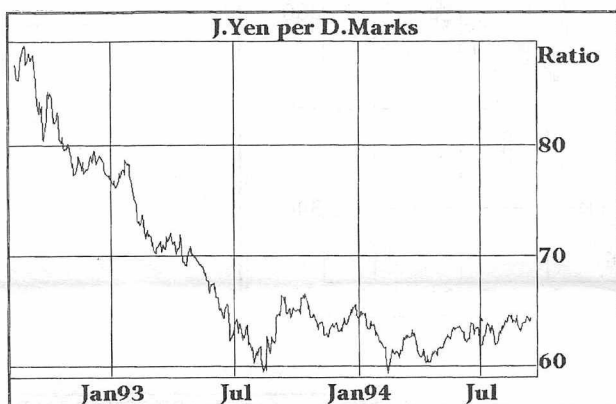
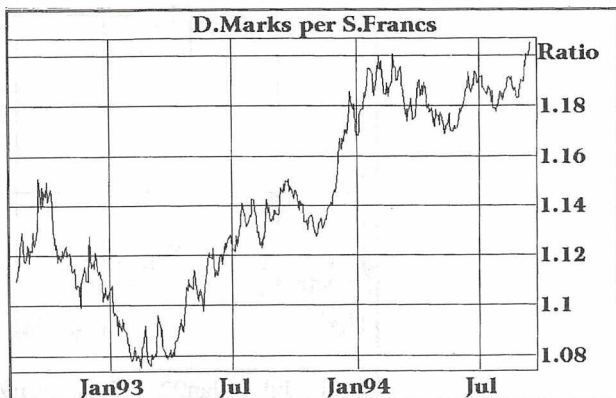


Chart 8



**CHINA**

## A bull in a china shop

**China and Commodity prices: a monetary note:** It may not be sufficiently appreciated that the accelerating Chinese inflation, now hitting 24% per annum, can have at the margin an explosive impact on global commodity prices.

Here's the logic: Chinese inflation is caused by surging money supply, which has grown almost 35% year on year. This 35% growth translates into approximately US\$100 billion, given that total money supply in China equalled 3 trillion yuan and the rate of exchange remained at around 8.7 yuan/US dollar. So long as the currency does not depreciate

(itself probably a function of foreign investor interest in the country), this dramatic increase in the stock of yuan is adding to the stock of "international" currency. To appreciate the magnitude of this phenomenon, we should note that the increase in China's money supply, denominated in US dollars, was almost equal to the increase in the US broad money supply during 1993.

There is no doubt that China has become, at least monetarily speaking, a major league player. Commodity traders, please take note.

**STOCK INDEX FUTURES**

## We'd like to be short...but not yet

Twice during the past six weeks we advised putting out a short position on S&P 500 futures (see Hotline Update for Aug. 2 and Sept. 2) with little luck but practically no loss. (In fact, those who covered the last short position on the morning of Friday, September 9, rather than Thursday 10:40 am as per flash update, managed to extract a profit out of the trade as the market opened around 469.50.)

Equity prices continue to defy rising interest rates, thanks to the powerful upward thrust of corporate earnings and an extraordinary mutual fund mania that feeds on itself (see

Chart 10). And while the Dow Jones Industrials price-earnings ratio has justifiably fallen (it now stands at 20.5), it is still above a more normal long-term 14-16. In the meantime, dividend yields at 2.8% are grotesquely uncompetitive with money-market yields, and getting more so every day.

We remain keenly interested in establishing a short position, although we admit that being short bonds has been a great deal more rewarding thus far.

**STRATEGY:** *Keep in close contact.*

Chart 9

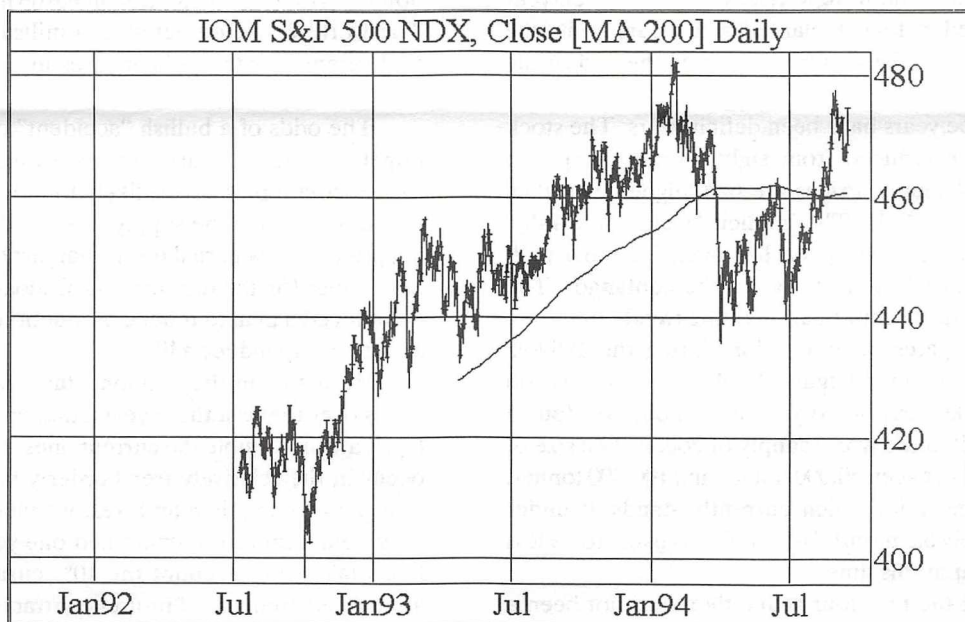
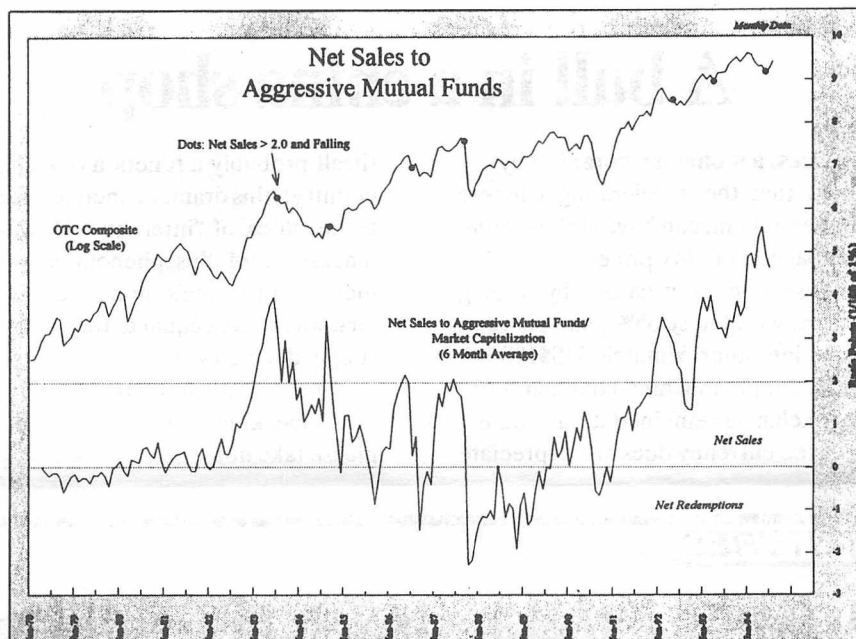


Chart 10



Sources: Investment Company Institute  
The Zweig Forecast

## COMMODITIES

### Cocoa

When we first recommended buying cocoa three years ago, our thesis was that because of the extremely low prices paid to producers, cocoa production was likely to remain fixed at 1991-92 levels, while consumption would continue to grow at its trend rate of 4%. In the ensuing string of inevitable production deficits prices would have to rise. Given the seven-year lead time required before a planted tree bears fruit, the price-rise was likely to be significant toward the end of the cycle.

The past three years have been deficit years. The stock overhang has been reduced from eight months' supply to about 5.5 months' supply. Prices are 62% higher than they were at their lows of 1991. The implicit "yield" on a fully-margined contract of cash cocoa has been 8% (18% cash price increase minus 10% shrinkage in the contango). The current year promises a continuation of the trend.

The first estimates of production during the 1994-95 crop year, which officially begins October 1 — the season opened three weeks early in Ivory Coast — point to a fourth consecutive deficit in the world supply of cocoa. The size of the deficit is put at between 50,000 tonnes and 100,000 tonnes. The stock-to-usage ratio, which currently stands at under 50% (approximately 5.5 months' of supply), is likely to be less than 45% next year at this time.

So far during the past four years, there has not been a single significant "accident" that would have served to hurry

on the bullish case. By "accident," I mean an aberration to the most likely scenario as suggested by the trend. The freeze in Brazil, which this summer rushed the coffee market into a volatile price rise that would otherwise have taken several years to accomplish, is a dramatic recent example of a bullish accident. If anything, the bullish case for cocoa has suffered from bearish accidents: In the wake of its political and economic turmoil, consumption in eastern Europe turned limp. The world recession acted as a millstone to demand. This past summer, extreme heatwaves in Europe and Japan curtailed demand more.

The odds of a bullish "accident" occurring and adding impetus to the bull market increase with time. World demand for chocolate products is likely to move toward full restoration this year. On the supply side, producers are still receiving prices so low in real terms that just this morning (Sunday, September 18), the International Cocoa Organization (ICCO) announced a plan to reduce production by 375,000 tonnes in an attempt to induce a lift.

We maintain the opinion, stated several times in these pages over the past three years, that cocoa prices will rise to levels at least double the current ones. If the price rise should occur in the relatively trend-orderly fashion it has over the past three years, then an investor's yield should be 8% on a fully collateralized, unmargined one-year forward position. (This takes into account the 10% current contango — the annualized premium of futures contracts prices to cash prices — which must shrink as the position moves toward cash).

Leveraged conservatively at three times margin, the yield becomes 24%.

The likeliest scenario then calls for the conservative investor to get paid 24% on capital in order to hold an asset that is much more likely to appreciate by more than its recent trend than it is to fall short of that trend.

**STRATEGY:** *Stay resolutely long.*

## Sugar

Few markets appear more appealing than sugar. Nearer futures contracts are trading at higher prices than deferred contracts, thus indicating genuine tightness in supplies. As Chart 12 indicates, prices have managed to break out of the oppressive selling resistance overhead. The implication of these technical indicators is in keeping with what we know about the fundamental picture.

After two successive years of supply deficits, sugar production was forecast to rebound this year. A supply/demand balance was expected. These optimistic forecasts have been dashed by the combination of extremely hot and dry weather in Europe this past summer, which served to reduce beet crop yields, and by adverse conditions in China. Estimates of the 1994-95 crop year now call for a deficit of as much as 1.0 million tonnes.

International sugar trade will find difficulty absorbing so high a shortfall. After the past two years, the stock-to-usage ratio wafts fragily at beneath 30%, which is typically a critical level. What's surprising is that commercial users of sugar have not reacted to the deterioration of production with greater alarm.

In fact, as indicated by the Traders Commitments Reports published by the exchange every other Friday, the single soft spot in the technical picture is the relative absence of commercials from the long side of the market. These reports suggest that the recent price rise has been mostly the work of

speculators.

It has come to be considered axiomatic amongst many technical analysts that no market can blossom into a fully developed trend without the commercial component not only present but leading the way. This "axiom" is a corollary of the ur-maxim that "commercials are right and speculators are wrong." If such were the case, then the current sugar action must be regarded as suspect. I, for one, do not share this regard.

Many markets, notably major bull markets, have developed leaving commercial users behind and bewildered. I am thinking especially of the cocoa market in the mid-1970s when Gill & Duffus, the world's most significant forecaster, led a rout of the commercial interest by losing a reported \$150 million. This should not surprise; commercials operate within business parameters, which by their very nature tend to be conservative. Fueled by dreams of riches, it is the speculative element that dares predict the the unthinkable. It appears commercials are right and speculators are wrong, because the vast majority of price moves tend to be small, i.e. within narrow parameters of ordinary commercial business. As every speculator must ruefully acknowledge, very, very few moves tend to live up to the imagination's forecasts.

The current sugar market has the earmarks of one of the few exceptions. The technical picture and the fundamentals both argue for much higher prices ahead. The relative complacency of the commercial element supports rather than detracts from the argument.

**STRATEGY:** *You are long as per our last comments. Remain long.*

## Coffee

**STRATEGY:** *Remain long as per comments of June 20.*

— David B. Rothberg

Chart 11

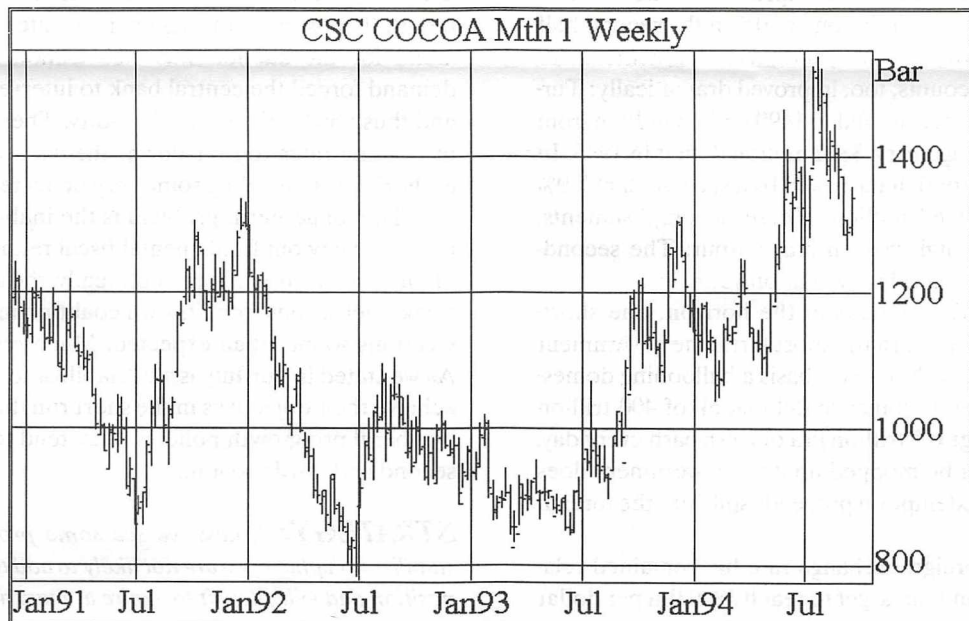
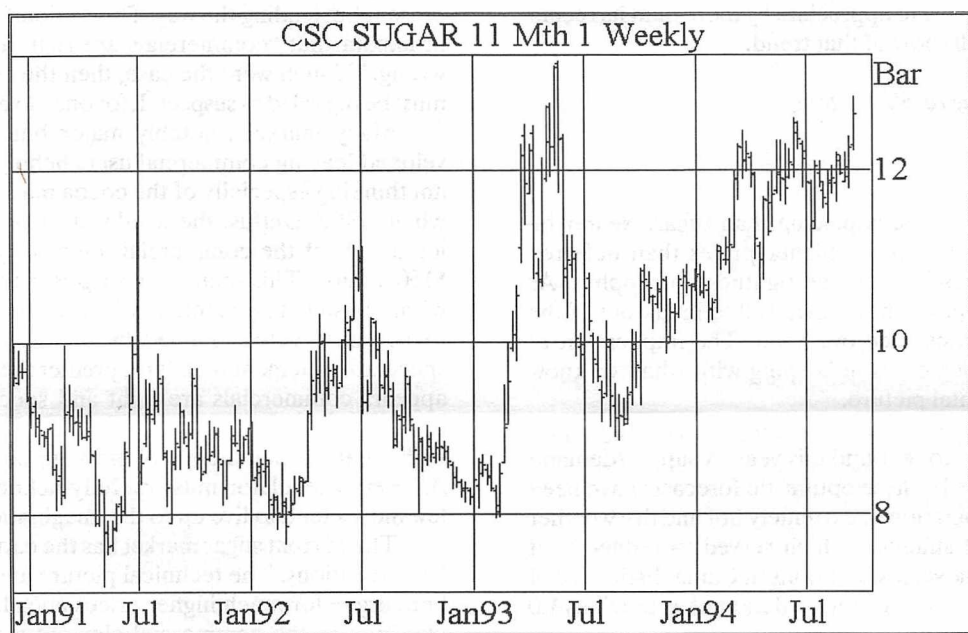


Chart 12



## FRIEDBERG CAPITAL MARKETS

# Turkey: much remains to be done

In our last issue, we recommended the purchase of Turkish lira Treasury bills based on our expectation that Turkey would successfully return from the brink of hyperinflation. The IMF-sponsored stabilization program has indeed been a success thus far. The monthly inflation rates for July and August were 1.7% and 2%, down from 24.8% in April. The Ciller government has pledged to keep inflation at 20% in the second half in the standby deal with the IMF, and this seems achievable.

The external accounts, too, improved dramatically: Turkey's current account surplus fell to \$490 million in June from \$581 million in May, against a \$892 million deficit in 1993. In July the foreign trade deficit narrowed by a spectacular 97.9% year on year, to \$26.88 million. These accomplishments, however, came at a high cost in real output: The second-quarter real GDP plunged 11.3% year on year.

There are two dark clouds in the horizon, one short-term and one longer term. In the short term, the government is rolling over on a very short-term basis a ballooning domestic debt: A three-month domestic debt stock of 400 trillion lira creates an average 6.5 trillion lira of fresh cash every day, an amount that must be mopped up if the government does not want to see the redemption proceeds spill into the foreign exchange markets.

Thus far, the foreign exchange rate has remained relatively well behaved and on target to reach 3800 lira per dollar

by the end of the year, as part of the IMF program. From time to time, however, in view of the Treasury's desire to impose a reduction in interest rates, it has been unable to roll over all the maturing debt, causing extreme nervousness in the foreign exchange markets. As an example, on September 12, the Turkish Treasury sold only 259 billion lira worth of three-month T-bills at an average annual rate of 87.6%; total demand for the auction was 4.05 trillion lira. The unfilled demand forced the central bank to intervene via dollar sales and thus absorb the excess liquidity. There is a clear danger in pushing rates too far down: the Treasury and monetary authorities are juggling some very delicate crystal pieces.

The longer-term problem is the inability of the government to carry out fundamental fiscal reform and the stalling of the privatization efforts. Politically, the government is very weak: Defections from its own coalition may force it to hold elections sooner than expected. Much remains to be done. As we stated in our July issue "stabilization programs tend to achieve their objectives in the short run, but, unless followed by liberal pro-growth policies, they tend to be followed by a second and third program."

**STRATEGY:** *Unless we see some progress in this post-stabilization phase, we are not likely to add to our present T-bill position and will allow it to expire at maturity.*

**FRIEDBERG CAPITAL MARKETS****Latest on TWA****Security:** Senior Secured Bonds**Coupon:** 10%**Maturity:** Nov. 3, 1998**Recent price:** \$58**Yield:** 27%

TWA announced its second-quarter results on August 15, 1994. Revenue was 11.7% higher and operating loss was 44% lower than in the second quarter of 1993. However, its net loss of \$58 million was worse than the \$52 million incurred the same quarter last year, which was attributable to much higher interest expense upon exit of Chapter 11.

In addition to the above encouraging news, TWA announced at the end of August the completion of negotiations with the machinists' union on work-rule changes and other cost-saving actions. A similar agreement with the pilots' union also was reached, pending a ratification vote. TWA is still negotiating with the flight attendants' union on work rule changes. All negotiations and ratification votes should be completed by the end of September.

According to TWA, the agreement with the machinists' union can save \$80 million to \$85 million annually for TWA. One important aspect of the agreement is the elimination of the snapback provisions under the previous wage concession agreement. In other words, their salaries would not return to the preconcession levels next year as agreed upon before.

If TWA can drop the snapback provisions with all the unions, it will be able to reduce annual operating expense by \$130 million to \$150 million. However, these figures are calculated from the preconcession expense level. If we use the current expense level as a base, which already reflected the wage concessions, the new agreements may produce annual savings of only \$20 million to \$30 million, which is mostly the result of work-rule changes. In particular, the new agreement with the machinists' union may save TWA only \$10 million to \$15 million annually from the current expense level.

We agree that TWA's new management has done a great job of renegotiating with the unions. The new agreements can bring TWA's cost structure more in line with its competitors and, therefore, are key to TWA's long-term survival. Nevertheless, we believe the cost-cutting programs are not sufficient to address TWA's most immediate and urgent problem: liquidity!

The company's 10Q filing showed that it had \$116 million cash on hand at the end of June 1994, which is in line with our estimate. It also claimed that approximately \$38 million cash could be raised by asset reversals and selling its subsidiaries, Midcoast Aviation and International Aviation Security (at the time of writing, TWA had already sold Midcoast to Sabreliner Corp. for an undisclosed amount). On the other hand, cash interest payment for the second quarter was \$45.8 million. If the cash interest expense runs at the same quarterly rate, TWA's cash (cash on hand plus future operating cash flow) will be able to support interest payment for only four more quarters. This scenario already assumed that Carl Ichan would agree to refinance the \$190 million facility due

January 1995.

Since Jeff Erickson, TWA's new CEO, said that the company was not seeking any buyer or merger partner (which we believe is because nobody is interested in TWA) and almost no more assets are available for sale, we can only expect the liquidity problem to be solved by improved operating cash flow. Our outlook for TWA's ability to generate sufficient operating cash flow is weak for the following reasons:

**1) Fare discounting is still prevalent.** Continental Airlines recently initiated a fare cut of up to 50% on domestic travels between September and December 1994, which was followed by most major airlines including TWA.

**2) TWA now has only one major hub,** St. Louis, which unfortunately is also the center of operations of Southwest Airlines. Southwest is one of the most cost competitive regional airlines. Its cost per available seat mile is lower than the average of major full-service airlines by over 25%. Even with the cost-cutting programs, TWA will not be able to match Southwest's cost structure.

**3) Load factor is still below breakeven level.** TWA's load factor in the second quarter was 64.6%, an improvement from 63.7% in the same quarter a year ago; but the breakeven load factor also rose to 71.7% from 71.3%. TWA recently announced a 12.3% year-to-date increase in revenue passenger miles, and an 11.5% increase in available seat miles over the same period. Although that implies a slight improvement in the load factor, it is still quite far away from the breakeven level.

**4) Oil price is expected to remain firm.** TWA's average fuel cost is the highest in the industry owing to its old fleet. The continued firmness in oil price will hinder TWA's ability to improve its operating margin. The company's lack of capital resources to update its fleet will exacerbate this problem.

Jeff Erickson recently told the press that TWA would negotiate with all secured creditors to restructure the debt payments as soon as negotiations with all the unions are completed. While he has not given any details, rumors on the market indicated that the proposal would include debt/equity swap and interest payment deferrals.

Both the stock and bonds of TWA have rallied on the news of successful negotiations with unions and possible debt restructuring. The 10% bonds have moved up to the \$58 to \$60 range after dipping to as low as \$50 in late July. The common stock climbed from \$1 in early August to as high as \$5 on September 7, and then retreated to \$3.50 currently.

Although we do not yet know the terms of the proposed debt restructuring, it is hard to find any reason why bondholders would be willing to grant any concessions, not to mention a debt/equity swap. Since most of TWA's bonds are fully secured and the prospects of TWA's survival is highly uncertain even for the medium term, bondholders should not be willing to give up any of their claims against the underlying collateral. Bondholders will not hesitate to force the company into liquidation if that is the only way to maximize the return on their investments.

## Update on Atari Corp.

**Security:** 5.25% convertible debentures, due 04/29/02

**Recent price:** \$57.50

**Yield:** 15%

**Recent stock price:** \$5.75 per share

Atari announced its second quarter results on August 1. Sales were \$8.2 million, up 43% compared with the same quarter last year. Operating loss at \$3.88 million was slightly below the \$3.95 million last year. The lack of improvement in operating results despite a big jump in sales was due to the much lower gross margin of multimedia products. Atari's aggressive pricing of the 64-bit Jaguar system at \$250, versus the \$399 retail price of 3DO's 32-bit machine, has lowered the overall gross margin to 15% from 20% last year, when Jaguar was not yet on the market.

Our analysis suggested that Atari has shipped approximately 73,000 to 75,000 units of Jaguar in the first two quarters of 1994. That was below the target of 90,000 to 100,000 units set by Atari. However, we do not consider the actual figures bad, since Jaguar was available only in a few cities, and the number of games available is very limited.

It seems there is no dispute as to the technical superiority of Jaguar's hardware. Recently it has won another award: the European Computer Trade Show Award for "Best Hardware of the Year." The most advanced competitive machine is 3DO's 32-bit system. Sony claimed to be introducing a 32-bit system in Japan by this Christmas and in the US next year. Sega said it would have a 32-bit machine available by late 1995.

As a result, the window of opportunity for Atari is still there. The only factor that has hampered Jaguar's sales is the lack of software. Currently there are only five games available. Three more games are coming out by October. Atari said that there would be 30 to 50 games available by Christmas. We are less optimistic. We believe 20 to 25 games are more likely. However, even with 20 to 25 games, sales of Jaguar can skyrocket to 100,000 to 150,000 units for the Christmas season.

Atari had \$35 million cash at the end of June 1994. We believe that with more games rolling out and sales of Jaguar increasing, it can probably raise additional financing to launch an aggressive national advertising and promotion campaign. In addition, Atari has licensed the Jaguar technology to Sigma Designs Inc., which will develop a board to enable PC users to play games designed for Jaguar. Since the market size of PC users is huge, the agreement will provide Atari with the potential of substantial future royalty income.

While we are cautiously optimistic about Atari, its common stock and convertible bonds are no doubt highly speculative. 3DO's 32-bit machine is currently the strongest competitor. Although it is more expensive than Jaguar and its hardware capabilities are not as good, it has over 100 games available. Besides, the 3DO machine uses compact disks, which is a format compatible with the increasingly popular CD-ROM for personal computers. Since its introduction in December last year, sales have reached 200,000 units worldwide.

We believe Jaguar certainly offers a better price/performance ratio than 3DO's system. However, very few consumers would buy a machine that has only a few games to play on. If Atari can come out with enough games this Christmas, it will be able to gain a significant market share. Otherwise, its market position could erode rapidly. Therefore, the coming Christmas will be a make-or-break sales season for Atari, and we will be monitoring the situation very closely. Stay tuned.

## Convertibles' Investment Value

For the past two months, we have seen a divergence between the US bond and stock markets. The Fed's decision to raise both the Fed funds and discount rates by 50 basis points on August 16, together with some weaker-than-expected economic figures, caused a temporary rebound in the bond market. However, stronger-than-expected producer price index and capacity utilization rate numbers that came out in September have put the bond market back on the downward trend. Yield on US 30-year Treasuries has gone up to 7.8% from 7.3%.

On the other hand, the stock market has remained strong. The S&P 500 index has rallied by 5%, standing at 471 compared with the level in the 450s in July. We believe the stock market has been driven by strong earnings of cyclical stocks, especially commodity-related, and continued money flow into equity mutual funds. The divergence between the stock and bond markets may last for another few months before the former is finally choked off by a continued rise in interest rates.

Owing to the diverging trend in the equity and fixed-income markets, prices of our convertible bonds have remained little changed. For some issues, estimated investment value in fact has increased slightly since our last update. We believe the reason is that the strong earnings performance of companies has improved the credit quality of many low-grade issuers. In other words, at this stage of the economic cycle, the positive impact of credit quality improvement has offset or outweighed the negative impact of higher interest rates on low-grade corporate bonds. Therefore, the prices of the convertible bonds in our portfolio have been relatively stable.

Consistent with past results, the convertibles of California Microwave and Coeur D'Alene still traded with a large premium over their estimated investment value. Their prices have been moving in tandem with those of the underlying equity, since the prices of both stocks are getting close to the bonds' conversion levels.

The convertibles of Mastec, Datapoint, Atari, and Glycomed all traded below their estimated investment value. The Mastec convertibles' price may be capped by the call provision. We believe that the other three issues have been oversold; we should see some price corrections in the near future.

— Edison Lee

Chart 13 – Convertibles' investment value

Issuer	ATC	MASX	CDE	CMIC	DPT	GLYC
Credit rating	Caa	B3	CCC+	B	Ca	CCC
Recent price	\$57.5	\$97.3	\$96.3	\$105.0	\$47.5	\$52.0
Yield	15.0%	12.9%	6.6%	4.6%	21.1%	19.4%
Maturity	4/29/02	11/15/00	6/10/02	12/15/03	6/1/06	6/10/02
Estimated Investment Value	\$68.8	\$104.2	\$73.2	\$69.4	\$65.0	\$78.3
Over (below) investment value	(19.7%)	(7.1%)	24.0%	33.9%	(36.8%)	(50.5%)

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

Chart 14 – FOREIGN CURRENCY BONDS

DATE: September 16, 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
<b>DEUTSCHE MARK DENOMINATED BONDS</b>					
Bank of Nova Scotia 5 5/8% 7/5/96 RRSP	98.75	99.6	5.87		May-07
World Bank 5 7/8% 4/02/97 RRSP	101.6	102.45	4.74		Feb-04
World Bank 9% 13/11/00 RRSP	110.15	111	6.75		Nov-13
Kingdom of Denmark 6 1/8% 15/04/98	97.1	97.95	6.78		Apr-15
Argentina 8% 5/10/98	98.85	99.7	8.09		Oct-05
Bk. Foreign Eco. Affairs 7% 29/3/96	89.5	90.35	14.44		Mar-29
Kgdm. of Spain (Floating) 29/6/02 (semi)	99.1	99.4		4.9375	Dec-29
<b>FINNISH MARKKA DENOMINATED BONDS</b>					
Rep. of Finland 11% 15/6/95	101.65	102.4	7.30		Jun-15
<b>ITALIAN LIRA DENOMINATED BONDS</b>					
Nordic Inves. Bk 12 3/8% 19/04/96	100.85	101.7	11.02		Apr-19
General Electric 11 1/2% 7/02/95	99.8	100.65	9.04		Feb-07
<b>SWISS FRANC DENOMINATED BONDS</b>					
General Electric 4 3/4% 2/7/98	97.85	98.7	5.13		Jul-02
<b>DANISH KRONE DENOMINATED BONDS</b>					
Kgdm. of Denmark 9% 15/11/96	100.85	101.7	8.08		Nov-15
<b>ECU DENOMINATED BONDS</b>					
United Kingdom 9 1/8% 21/02/01	101.6	-	-		Feb-21
<b>BRITISH POUND DENOMINATED BONDS</b>					
Kgdm. of Sweden 8 3/4% 29/5/96	100.00	-	-		May-29
<b>FRENCH FRANC DENOMINATED BONDS</b>					
Credit Lyonnaise 9 1/2% 23/12/96	103.65	104.5	7.23		Dec-23
<b>JAPANESE YEN DENOMINATED BONDS</b>					
World Bank 5 3/4% 7/8/96 RRSP	103.65	104.5	3.23		Aug-07
<b>CANADIAN DOLLAR DENOMINATED BONDS</b>					
Ontario Hydro 10 7/8% 8/01/96 (semi)	103.1	104.6	7.07		Jan-08
Eksportfinans 7 3/4% 5/11/97	97.55	-	-		Nov-05
Royal Bank of Canada 9 1/8% 7/1/97	100.55	-	-		Jan-07
<b>SOUTH AFRICAN RAND DENOMINATED BONDS</b>					
ESCOM 12% 1/5/96 (semi)	96.5	97.35	13.86		Nov-01
<b>AUSTRALIAN DOLLAR DENOMINATED BONDS</b>					
Commonwealth Bk. of Australia 9 3/4% 15/5/96	101.50	-	-		May-15
<b>TURKISH LIRA DENOMINATED BONDS</b>					
Government of Turkey T-Bill 15/11/94	86.84	-	-		Matures Nov-15
<b>NEW ZEALAND DOLLAR DENOMINATED BONDS</b>					
New Zealand Gov't 10% 15/7/97 (semi)	102.55	103.4	8.61		Jan-15
Fletcher Challenge 10.75% 15/12/97 (semi)	99.00	99.85	10.79		Dec-15
Fletcher Challenge 10.15% 30/11/98 (semi)	96.6	97.45	10.91		Nov-30
Corporate Investment Ltd. 13 1/2% 19/6/95 (semi)	82.15	84.65	28.91		Dec-19
Tranz Rail Ltd. 10% 15/10/99 (semi)	95.45	96.3	10.97		Oct-15
DB Group 7% 30/6/96 (semi) matures @ 85	87.4	88.25	5.73		Dec-30
<b>ARGENTINEAN PESO DENOMINATED BONDS</b>					
BIC V Fixed/Floating 1/5/2001 Callable in full on every interest date	78.7	79.55	12.83		4th day of mth.
<b>U.S. DOLLAR DENOMINATED FIXED CONV. BONDS</b>					
Dalpoint Corp. 8 7/8% 1/6/06 CV@18.11p/sh (semi)	47.75	49.75	20.22		Dec-01
Burnup & Sims 12% 15/11/00 CV@16.79 p/sh (semi)	97.25	-	-		Nov-15
Atari Corp. 5 1/4% 29/4/02 CV@16.31 p/sh	56.75	58.25	14.72		Apr-29
Coeur D'Alene 6% 10/6/02 CV@26.00 p/sh	94.25	95.75	6.72		Jun-10
Glycomed 7 1/2% 1/1/03 CV@14.06 (semi)	52.25	-	-		Jan-01
California Microwave 5 1/4% 15/12/03 CV@28.44 p/sh (semi)	103.25	104.75	4.61		Dec-15
<b>U.S. DOLLAR DENOMINATED FIXED RATE BONDS</b>					
Farm Credit Corp 7 3/4% 10/06/96 RRSP	101.9	102.75	5.99		Jun-10
T.W.A. 10% 3/11/98 (semi)	56.65	57.5	28.04		Feb-01
<b>U.S. DOLLAR DENOMINATED FLOATING RATE NOTES</b>					
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 (qtlly), callable @100	99.74	100.04		4.5	Sep-30
Bocon 1/4/01 (30 day LIBOR) starts accruing May 1, 1997	85.6	86.45	12.48		May-01-97
Argentina: Series L:FRB 31/3/05, 6 mo. LIBOR+13/16 (semi)	75.25	76	11.29	5	Sep-30

**GOLD** (in ounces, at market prices, can also be held in your bond account) client eligibility determined at point of sale.

Chart 15 – Recommended current portfolio allocations

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

## HOTLINE UPDATE

### Tuesday, July 26:

No new recommendations.

### Friday, July 29:

No new recommendations.

### Flash Update, Tuesday, August 2, 10:25 am:

Re-establish short side of September S&P at the market, currently trading at 462.50. Place initial stops at 468.00, good anytime.

### Tuesday, August 2:

No new recommendations; however, this is a recap of this morning's flash update. We established short side of September S&P at the market, then trading at 462.50. Initial stops were placed at 468.00, good anytime.

### Flash Update, Thursday, August 4, 1:30 pm:

Raise stops in October platinum to 403.00, close only from 396.00.

### Friday, August 5:

No new recommendations; however, this is a recap of this week's hotline updates: Tuesday, August 2 via flash update at 10:25 am we reestablished short side of September S&P at the market, then trading at 462.50. Initial stops were placed at 468.00 good anytime. Thursday, August 4 via flash update at 1:30 pm, stops were raised in October platinum to 403.00, close only from 396.00.

### Tuesday, August 9:

No new recommendations.

### Flash Update, Thursday, August 11, 10:00 am:

Lower stops in September S&P to 465.00 from 468.00, good anytime.

### Flash Update, Friday, August 12, 9:05 am:

Buy December silver at the market, currently trading at 524.00; place stops at 510.00, close only.

### Flash Update, Friday, August 12, 11:35 am:

Cover short September S&P at the market, currently trading at 462.10, cancelling the 465.00 stop, good anytime. We repeat this morning's flash of 9:05 am: Buy December silver at the market, then trading at 524.00; place stops at 510.00, close only.

### Friday, August 12:

No new recommendations, however, this is a recap of the hotline recommendations made during this past week. On Thursday, August 11 at 10:00 am, we advised to have stops lowered in September S&P to 465.00 from 468.00, good anytime. At 9:05 am this morning via flash update we advised the purchase of December silver, then trading at 524.00; stops should be placed at 510.00, close only. At 11:35 am this morning via flash update we advised to cover short September S&P at the market, then trading at 462.10, cancelling stops at 465.00, good anytime.

### Tuesday, August 16:

No new recommendations.

### Friday, August 19:

No new recommendations.

### Tuesday, August 23:

One new recommendation at 4:20 pm: Reinstate long gold positions. Buy December gold at the market; initial stops were placed at 379.00, close only.

### Friday, August 26:

No new recommendations for today; however, this is a recap of the recommendation for this week: On Tuesday, August 23, we advised reinstating long gold positions at the market; initial stops were placed at 379.00, close only. December gold opened on Wednesday, August 24 at 387.60

### Tuesday, August 30:

No new recommendations.

### Flash Update, Wednesday, August 31, 4:35 pm:

Buy December crude oil at the market. Protect this long position with stops at 16.90, close only.

### Flash Update, Friday, September 2, 10:40 am:

Sell September S&P at the market; place initial stops at 475.60, good anytime. September S&P is currently trading at 470.35

### Friday, September 2:

No new recommendations; however, this is a recap of this week's flash updates. Wednesday, August 31 at 4:35 pm via flash update: Buy December crude oil at the market; protect this long position with stops at 16.90, close only. December crude opened on Thursday, September 1 at 17.70. On Friday, September 2 at 3:55 pm via flash update: sell September S&P at the market; initial stops were placed at 475.60, good anytime. September S&P was then trading at 470.35.

### Flash Update, Thursday, September 8, 10:40 am:

Cover short September S&P at the market, currently trading at 472.30.

### Friday, September 9:

No new recommendations; however, this is a recap of this week's flash. Thursday, September 8 at 10:40 am we advised to cover short September S&P at the market, then trading at 472.30.

### Flash Update, Tuesday, September 13, 12:01 pm:

Liquidate long December crude oil positions at the market, currently trading at 17.52, cancelling the 16.90 stop, close only.

### Friday, September 16:

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

1. On Thursday, August 4, we raised stops on October platinum to 403.00, close only, from 396.00.
2. On Friday, August 12, we advised the purchase of December silver at the market, placing stops at 510, close only; December silver was trading at 524.
3. On Tuesday, August 23, we advised the purchase of December gold at the market; stops were placed at 379.00, close only. On Wednesday August 24, December gold opened at 387.60.

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