

FRIEDBERG'S

COMMODITY & CURRENCY COMMENTS

Friedberg Commodity Management Inc.



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Bonds in a gaming environment

For some time now, bonds — the 5- to 30-year variety — have ceased to be investments. Rather, they've become trading, or shall we say punting?, vehicles.

It couldn't be otherwise. No one would *seriously* purchase 6%, 7%, or 8% long-term obligations to earn just 6%, 7%, or 8% per annum. Not in a fiat money regime, whose brightest spokesmen are unable to explain, let alone track and control, monetary aggregates. And not when governments have for all practical purposes lost control of their budgets and their escalating debts. If neither the real value of money nor the real value of debt can be trusted, why, then, would anyone buy long-term bonds? The answer lies in the fact that it is possible to earn enormous returns, multiples or mega-multiples of the going-in yields, *via leverage*. Since long-term government securities enjoy excellent liquidity and no risk of default, they can be used as collateral to borrow short-term funds. The greater the spread between short- and long-term funds and the greater the leverage (in some cases, dealers were able to borrow against 100% of the value of the bonds, implying an infinite rate of return), the higher the return. In a typical case, traders borrowed short-term money at 3% to fund the purchases of two- to five-year securities yielding 6%, putting up perhaps 2% of the value of the transaction. The result: a 150% return. And, if to boot, the underlying bonds advance in price, the return can be even more astronomical.

This, of course, is not new. It is what happened on a massive scale between 1990 and 1993, as the Fed lowered the cost of overnight money to well below the yields obtained on long-term obligations.

It serves, however, to answer our earlier question: Why would *anyone* buy long-term bonds? Because 6%, 7%, and 8% bonds can be enormously profitable when financed at absurdly low rates. The "carrying" activity of dealers and large speculators buying bonds and borrowing funds pushed bond prices ever higher, producing a wonderfully virtuous effect. *Cash traders* (banks and bond mutual funds) began to join in the bandwagon — not because they could earn 6%, 7%, and 8%, but because rising bond prices produced double digit returns, like 25% per annum!

There was nary an investor in sight (by "investor," we mean someone interested in earning the *going-in* yield). Little wonder that the decline in bonds is proceeding even as infla-

tion remains low and "presumed" real rates are high. Bonds were bought to trade, not to hold; when interest rate expectations changed, the buyers evaporated. In 1994, all the unfortunate holders of long-term bonds will suffer *negative returns* despite the "healthy" 6%, 7%, or 8% coupons.

Interestingly, while many of the "carry" traders were wiped out by the debacle, new ones have emerged as the Fed has allowed funds to remain "cheap" at 4½% to 4¾%. Lacking the "wind at their sail," however, they too will be doomed.

Dealers and speculators, tempted by the still-wide yield gap (in some cases, as much as 300 basis points), need a market that, at the very least, stands still. This is unlikely as cash traders, who amassed hundreds of billions of dollars over the past five years, turn increasingly to the sell side; the banks because of strong loan demand (Charts 1 and 2), and the bond funds because of continued net redemptions.

Moreover, the Fed is likely to continue raising rates, even if only at a gradual pace, keeping *expectations* negative. Cash traders, looking to earn returns in excess of the going-in yields, are therefore unlikely to become net buyers in this environment.

Given the high level of uncertainty associated with the future value of money and debt present in our democratic

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Contributions by Albert D. Friedberg, Alan Reynolds, and Edison Lee.

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

societies, a *premium* rate must be paid to *cash investors* before they are persuaded to enter the market. This rate must be high enough to lure them away from the safety and profitability of money market instruments.

Only a very determined central bank, committed to preserving purchasing power, can lure cash investors to give up attractive short-term rates. It is paradoxical, but true nonetheless, that when the short-term returns are the most attractive in relative terms (i.e., when the yield curve turns negative), the cash investor leaves the short end of the market and becomes a buyer of long-term securities. Why?

Clearly because he has become convinced that the present value of the existing coupons will exceed the present value of rolling short-term deposits. The cash investor does not buy bonds because he believes he can obtain returns in

excess of the ongoing yield; he buys them because the going-in yields to maturity will, in his opinion, exceed the returns he's likely to obtain by rolling over 30-90 day deposits over 5-30 years. The buyers of US Treasuries in 1981-82 were cash investors, willing to give up stupendous 19%-20% short-term yields in the belief that lower yielding long-term bonds would provide them better long term returns. They were richly rewarded.

Bond buyers today are traders and punters, indifferent to the actual level of rates as long as they can profitably "carry" these securities. They are fair-weather friends, lacking any sort of conviction. Like hot potatoes, bonds move around the financial circuit, pressing prices ever lower.

Forget inflation. Forget real rates. Bonds will continue to fall until they rest in the secure hands of the cash investor.

Chart 1

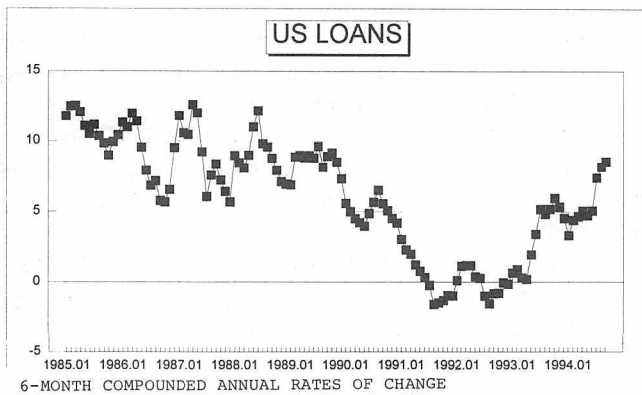


Chart 2

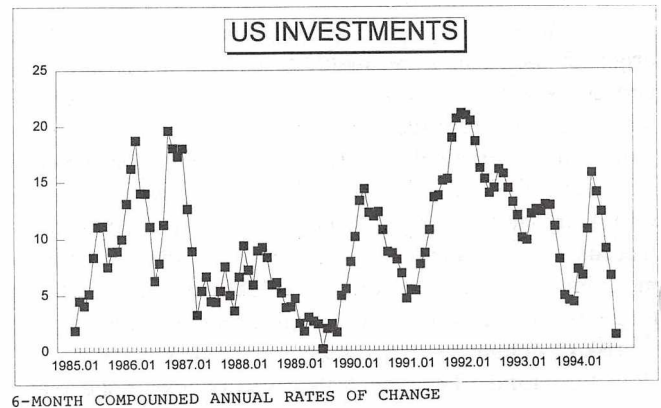


Chart 3 – TREASURY BONDS



CURRENCIES

The upside is in the Swissie

The US dollar fell to a two-year low against the DM and Swiss franc and to record lows against the Japanese yen. Strange as this may be, the lack of drama associated with this drop may be due to the mystery surrounding it. After all, the US economy is booming, interest rates have risen, the budget deficit has diminished; by contrast Europe's economic growth has been moderate, and Japan remains mired in a four-year depression.

Since sentiment is not all that negative, the persistent selling pressure must come largely from current and non-speculative (at least in relation to the expected value of the currency) capital outflows. In the latter area we find capital searching for better investment alternatives in emerging markets: stocks, bonds, and physical facilities. Just via mutual funds specializing in emerging markets alone, US investors may be transferring in the neighbourhood of \$5 billion per month.

To this one must add direct stock market investments (via ADRs and/or directly), and depositors seeking high yields in countries such as Turkey, South Africa, Russia, and so on. And then there is the current account deficit, widening as a result of a growing trade deficit that soon will become *the* story in the dollar bear market. The emerging market mania and its institutionalization seem, however, the likeliest "culprits" in the dollar decline.

Although in recent weeks chartists have added their weight to the dollar, there is as yet, no bandwagon effect, as the fall has been punctured by relatively sharp rallies. Long-

term traders and economists remain friendly to the US dollar and particularly negative on the Japanese yen for the well-known reason that the extraordinarily high level of the Japanese unit has effectively strangled their economy. This is true, but as long as the dollar does not recover (thanks to a flatter yield curve at the front end? or the end of the emerging markets mania?), the yen bulls will manage to bury wave after wave of reasonable and rational yen bears (circular reasoning?)

Just as small leakages, if not quickly repaired, end in floods, the dollar decline threatens to lead to a rout as soon as the outflow feeds on itself and the bandwagon effect comes to the fore.

There is nothing so serious that a more determined and more aggressive Fed policy cannot fix: hoisting short-term rates so as to flatten the entire yield curve will stop the outflow to emerging markets; the resultant carnage will decimate them and a reflow of capital will begin. The US dollar should then sail upwards.

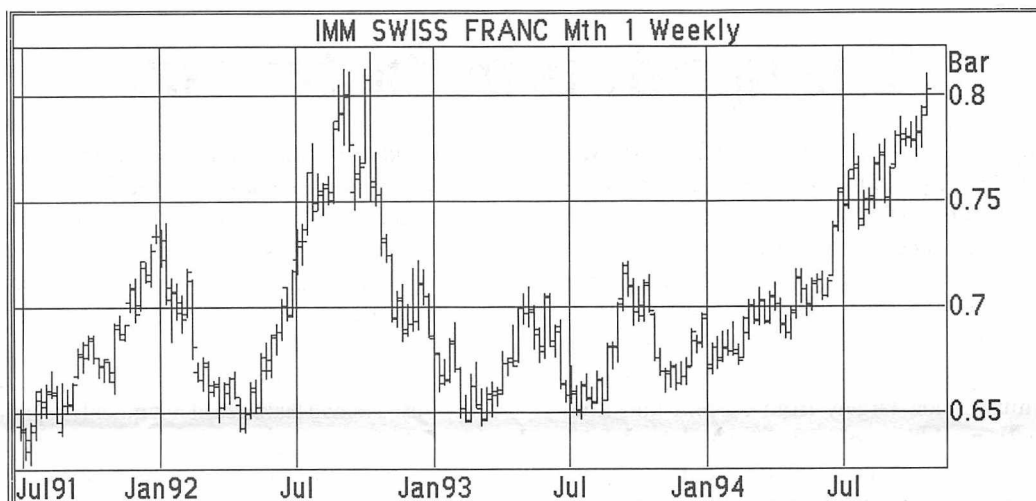
The long Swiss franc/short Japanese yen spread has been extremely profitable (see Chart 4). The massing of rational but highly vulnerable dollar/yen bulls positions convinced us, however, that there is more upside from here out in being long Swiss francs outright than in keeping the spread.

STRATEGY: *You should be long Swiss francs outright, after lifting the short yen position as per last Friday's recommendation (see Hotline Update, Oct. 21).*

Chart 4 – SF/JY



Chart 6



CANADIAN DOLLAR

Surprise, surprise

How far away is Canada from achieving a stable budgetary situation? The answer to this question has important implications for Canada's debt and currency markets.

A sustainable set of budget policies is one in which the government debt-to-GDP ratio is stable or declining. This requires that the stock of outstanding debt grows no faster than nominal GDP. Clearly, a budget balance is not required.

Whether the debt-to-GDP ratio is stable, rising or falling depends upon the following:

1. The relationship of real interest rates to real GDP growth;
2. The magnitude of the budget's primary operating surplus or deficit (the part of the budget that excludes debt service costs) relative to GDP; and
3. The ratio of debt to GDP.

A recent Goldman Sachs analysis of Canada estimated that the primary balance required for sustainability was 2.6% of GDP after assuming that real interest rates less GDP growth was 4%. Since, the 1995 primary budget balance for Canada was positive to the tune of 0.7% of GDP, the balance gap was only 1.9% of GDP. This gap was considerably smaller than Italy's 7.2% and Sweden's 9.8%. The analysis goes on to calculate budget sustainability at full employment given that Canada was still operating below full employment. The results were a highly satisfactory minus 0.2% of GDP — that is to say, at full employment Canada's total stock of federal debt would begin to decline relative to GDP.

Canada appears virtuous in relation to every major OECD country except for Germany and Japan. Their August 24 conclusion was bullish for the Canadian currency and for the Canadian debt markets.

We cite this analysis because it tends to give us a more balanced picture, or at least a picture of how global traders in contrast to local traders view Canada. The accompanying article by Alan Reynolds, however, reaches a far more pessimistic conclusion.

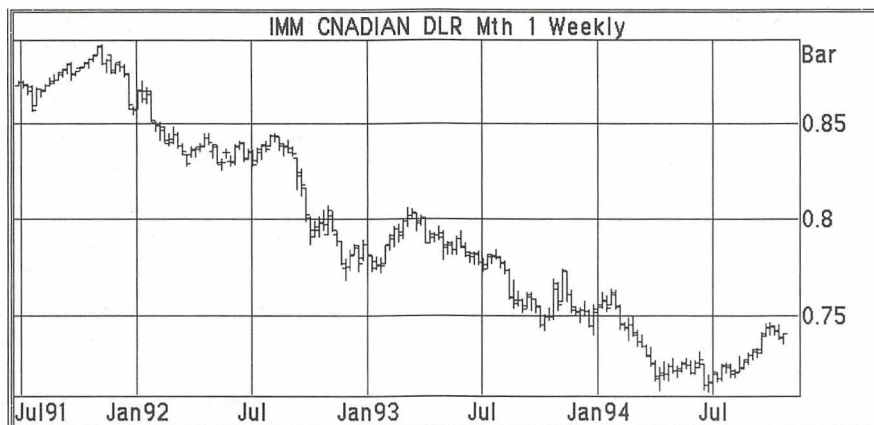
If the Canadian government wants to stabilize its debt-to-GDP ratio, it must cut spending rather than raise taxes; higher taxes will yield less rather than more revenue. This became clear this week, when Finance Minister Paul Martin produced some startling figures: In February, he said that Canada's GDP would be \$739 billion this year and that it would generate \$123.9 billion in federal revenues. It now appears that the GDP number will be \$744 billion (up \$5 billion) but revenues are being scaled back to \$123.7 billion (down \$200 million).

Avoidance and evasion are playing havoc with Finance. Moreover, the Goldman Sachs analysis does not take into account the provinces' explosive debt situation. Finally, the full employment budget gap measure assumes that the economy *can* achieve full employment. Provincial and Federal labor policies make the realization of full employment a chimera.

Global perceptions based on sometimes naive assumptions, and numbers crunched into sophisticated models have turned positive for Canada. Coupled with improving terms of trade, it should result, short- and medium-term, in a somewhat firmer Canadian dollar.

STRATEGY: *Remain long as per hotline update of October 5 with stops at 73.05, basis nearby, close only.*

Chart 8



CANADA

Canada is being taxed to death

By Alan Reynolds

Nobody doubts that tariffs can be "prohibitive," meaning they are so effective in stopping trade that they yield virtually nothing. But what about income taxes and sales taxes? Here, Canada provides a useful lesson.

After a very brief, successful experiment with lower tax rates in 1988-89, Canada's national government began to increase tax rates on just about everything. When surtaxes on high incomes did not work, they were followed by surtaxes on moderate incomes. The highest federal tax rate in Canada now applies to incomes of less than \$43,000 (US). Even President Clinton might not call that "rich." The top federal and provincial tax rate in Ontario has increased to more than 53% from 45% in 1989.

In 1991 a brutal 7% General Sales Tax, or GST, was piled on top of provincial sales taxes at least that high. There were other tax increases on cigarettes, gasoline, pensions and so on. In short, Canada tried every tax increase the Clinton administration ever dreamed of.

The graph shows what happened: Revenues fell. Even measured in shrinking Canadian dollars, revenues ended up lower in the first quarter of 1994 than they were in the first quarter of 1990, before the GST. Measured in US dollars, Canadian tax revenues fell 14.5% over the past four years. In the US, by contrast, revenues rose 26% in the same period — mostly before tax rates went up (though there was also a one-time windfall in April from retroactive taxes on 1993 income).

Stagnating or declining tax revenues are something quite new to Canada (though not to several European countries). The graph shows that revenues were rising steadily before 1990, nearly tripling since 1978 in Canadian currency. Tax rates were much lower back then, but revenues naturally grew because the economy grew. There was a recession in 1990-91. But there was a recession in the US, too, and US revenues are nonetheless 26% higher than they were four years ago. In any case, blaming such a long period of falling revenues on a weak economy gets cause and effect mixed up. No country has ever raised tax rates to the levels that Canada

has without experiencing chronic economic stagnation and wholesale tax evasion.

Canada's Keynesian rationale for higher tax rates was the same excuse employed by the Clinton administration: Such "fiscal restraint" would, according to high-ranking officials in the Finance Ministry, permit the central bank to keep interest rates down. In reality, however, Canadian interest rates rose with each new hike in tax rates (which reduced the net returns on savings).

The spread between Canadian and US Treasury bill rates widened to 530 basis points in 1990 from 281 basis points in 1988, the year tax rates were lowered. During the same period, the spread between US and Canadian bond yields likewise widened to 230 basis points, and it has remained about that wide ever since. When citizens take more capital out of their countries than others are willing to put in, their governments generally boost interest rates to bribe investors to hold the countries' IOUs.

Work incentives were mangled as badly as the incentives to invest in Canada. The labor force had increased by 1.9% a year from 1979 to 1989, but then growth slowed to 1.3% in 1990, 0.6% in 1991, and 0.3% in 1992. Unemployment is still well above 10%. As the Organization for Economic Cooperation and Development noted in a 1993 country survey, "unemployment would be even higher, had it not been for an unusually pronounced fall in the labor force participation rate." The share of the working age population that was either working or looking for work dropped to 65% by late 1993 from 67% in 1990. Among those Canadians who kept working, many chose to minimize taxes or maximize transfer payments by working part time.

The drop in the Canadian dollar (20% since 1991) is largely caused by an uncompetitive tax climate for both labor and capital. World investors do not like to invest in countries with rising tax rates. In 1993-94, investors preferred to invest in countries where the highest income-tax rates have been slashed to 20-35%, such as Hong Kong, Singapore, Brazil, and Argentina.

The reason capital flees from high-taxed countries into lower-taxed countries is no great mystery. When tax rates on sales go up, sales go down. When tax rates on labor go up, employees have to pay higher wages to attract and retain skilled people. When tax rates on profits, dividends, and interest income go up, savings and investment go down.

As a result, the Canadian stock market has been among the world's worst investments since 1989, offering even lower returns than simply holding cash. Since Canadians have been investing more in other countries than foreigners invest in Canada, the "capital flight" had to push the currency down unless it could have somehow been fully offset by an impossibly huge trade surplus. Even with the wider gap between Canadian and US interest rates since 1989 — which is another consequence of scaring capital away with steep taxes — the Canadian dollar was nonetheless bound to tumble.

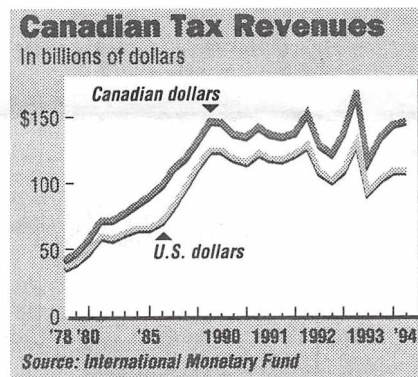
The weak currency means Canadians — and the Canadian government — have less buying power in the world. When the Canadian dollar falls, the government needs more Canadian dollars to make the interest payments on its large foreign debt. The increased tax rates after 1989 have thus increased the spending side of the government's budget, by sinking the currency and raising interest rates, as well as shrinking real revenues.

The higher income and sales taxes imposed in Canada after 1989 were counterproductive. They hurt the private

economy and, ironically, also greatly worsened the government's budget. It could be argued that the central government's taxes are literally tearing the country apart. That ought to make Canadians mad as hell. If we keep adopting similar tax policies in the US, we don't have to look very far to see where that will lead us. Just look at Canada. And weep.

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PRECIOUS METALS

Once-in-a-lifetime opportunity

The fourth attempt in 10 months to better the \$400/oz. level met resistance once again, causing prices to correct down to the \$386-388/oz. area. Silver met a similar fate around the \$5.75/oz. area, basis the nearby. The correction was accompanied by a substantial liquidation of the open commitment; big bulls (hedge funds?) are extremely light-footed, though willing to take repeated punishment for the glory of participating in the great breakout.

An examination of the commitment of traders reveals good commercial buying on the dips. Encouragingly, the dips seem to be shallower and shallower, at least thus far, portending an imminent upside breakout.

Significantly, option premiums have collapsed to near historic lows; the implied volatilities on the at-the-money February '95 gold and March '95 silver options traded this past Friday around 9.6% and 22% respectively. Options sellers have become emboldened by the tight ranges and are now giving away the house. As a result, precious metals bulls are being presented with a once-in-a-lifetime opportunity.

If you do not own futures, it behooves you to buy the incredibly cheap call options.

STRATEGY: *We had anticipated, given the large increase in the commitment, a deep correction, which prompted us to advise the liquidation of both gold and silver on October 5 (see Hotline Update). As the tech-*

nical situation improved, we advised reentering the long side on October 20 (see Hotline Update). Tight stops were placed on both gold and silver. Friday's decline in silver triggered our 5.4450 stop. This leaves our clients long gold and platinum with stops at \$391.20 and \$414.50, basis February 1995 and January 1995, respectively, close only.

Chart 9 – GOLD



Chart 10 – SILVER



STOCK INDEXES

First Chrysler, now GM

The automotive stocks, despite dramatic earning gains, continue under severe pressure.

Cyclical stocks can be subdivided into two categories: the primary producers and the manufacturers. At the beginning of an economic upswing manufacturers gain at the expense of producers. This seems rather logical as primary producers are still laboring under the weight of heavy inventories and weak prices. With a maturing of the upswing the benefits begin to shift towards the producers. Prices of steel, aluminum, copper, glass, chemical, plastics, and so on, typically the input of manufacturers, rise and eat into the latter's profit margin. It is because of this that Wall Street folklore has it that "when the steels rise, run for the hills."

Strong commodity prices should underpin the performance of primary producers. Nevertheless, it is getting late in the day for the market as a whole. No better proof can be had than last week's massacre of the GM stock.

In the meantime, liquidity is leaking out. Commercial banks have ceased adding to their investment portfolios; it is very likely that in the next few weeks we will begin to see net liquidation as financial intermediaries mobilize resources to accommodate rising loan demand.

The clock is ticking.

STRATEGY: Remain sidelined for now.

Chart 12

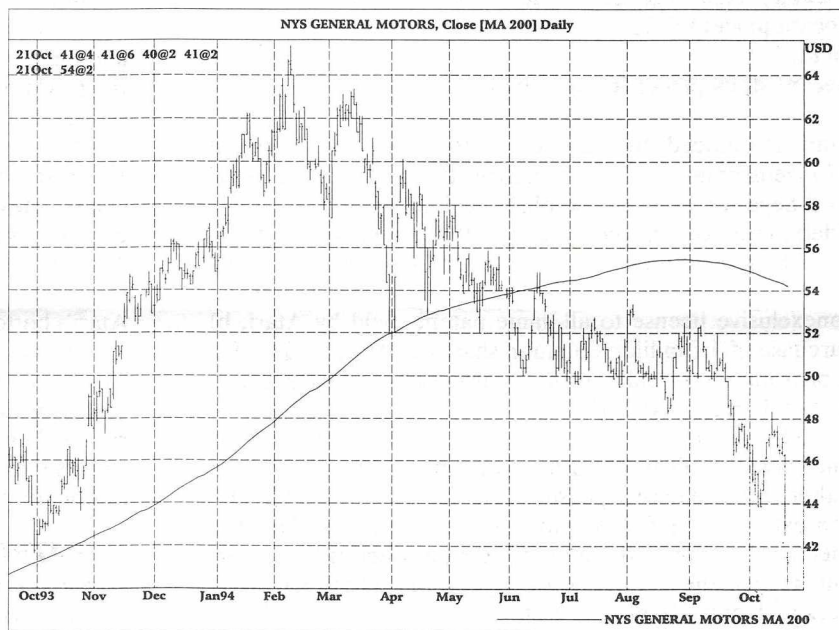


Chart 13



FRIEDBERG CAPITAL MARKETS

Atari receives \$90 million cash

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

Recent price: \$67.75

Yield: 12%

Recent stock price: \$6.5 per share

Atari announced an out-of-court settlement of its patent infringement lawsuit filed in October 1993 against Sega. Atari sued Sega for using the scrolling technology in the latter's video games, which is covered by a 1984 patent held by Atari.

The settlement includes a) a payment of \$50 million less Atari's legal fees to Atari, for Sega to receive a worldwide nonexclusive license to all game patents held by Atari, b) purchase of 4.7 million common shares of Atari by Sega for approximately \$40 million and, c) dismissal of all Atari's legal proceedings against Sega.

The lawsuit's success is unexpected and the settlement will boost Atari's cash position by almost \$90 million. Together with the existing cash, Atari will have over \$120 million capital at its disposal to fund its operations. This has effectively removed the market's concern about how Atari can finance the marketing of Jaguar and additional R&D work with only \$30 million cash.

The above agreement with Sega has significantly improved the prospects of Atari. However, as stated in our last month's update, the long-term survival of Jaguar, and in turn Atari, depends on whether enough games can come out early enough to preempt other players such as 3DO and Sega. Without the necessary games, Atari will only waste its money by massively promoting the product. Since the lawsuit settlement has substantially alleviated Atari's financial problems,

it should be able to concentrate on developing games for Jaguar.

One fringe agreement out of this settlement is that Atari and Sega will be allowed to convert each other's games for their own platform. In other words, Sega will have access to the games developed for Atari's 64-bit technology, and Atari will be able to convert Sega's games for its Jaguar platform. While some analysts described it as a form of strategic alliance in the electronic game industry, we see it more as Sega's efforts to get back something for the money it has to pay Atari. Since Atari will not be able to introduce Sega's games for Jaguar until late 1995, this will not have any impact on Atari's bottom line in the short run.

Atari's stock has been up by \$1 since the news came out. The bonds, too, have rallied to 67.75 from the high 40s. The cash infusion has dramatically reduced the company's bankruptcy/financial risk in the near term. On the other hand, the stock's rally may be limited as investors may want to see the roll-out of more games before taking action.

STRATEGY: *The cash infusion of \$90 million has largely solved Atari's financing problem for the next two years. Its financial risk, therefore, has been significantly reduced. We pointed out last month that the coming Christmas will be a make-or-break sales season for Atari. Now we believe we can hold out another six to 12 months to see how much an aggressive marketing program in combination with more games can push Jaguar's sales. We have put Atari's convertible bonds back on the new allocation model in the belief that the downside risk has been substantially reduced while the yield to maturity remains an attractive 12%.*

Update on Corporate Investments Ltd.

Security: 13.5% convertible notes

Maturity: June 19, 1995

Recent price: \$84.4

Yield to maturity: 31.4%

Recent stock price: 28¢ per share

(All dollar and cent figures are in New Zealand currency)

Since we recommended these convertible notes in October 1993, their price has risen by 6%. On top of that, investors have received two coupon payments and benefited substantially from the strong New Zealand dollar. All these factors combined, the notes provided a total return of close to 25% to date (measured against US dollar). At the current price level, we believe the notes are still a strong buy for risk-conscious accounts.

Corporate Investments Ltd. (CIL) recently announced its fiscal 1994 results. Its earnings before interest and tax (EBIT) increased 106% over the last year while its net income before extraordinary items rose 119%. However, an abnormal writedown of \$44.9 million associated with its Australian real estate holdings resulted in a net loss of \$37.5 million.

The impressive pre-writedown results were due to strong performance of CIL's two core businesses: Montana Wine and Truck Investments. Montana Wine was able to increase sales and EBIT in the face of slow industry growth. Increasing bottled sales and higher output of quality grapes should sustain Montana's profit margin expansion and thus strong financial performance in fiscal 1995 and 1996. On the other hand, the strong economic recovery in New Zealand boosted the EBIT of Truck Investments by almost 65%. Engaged in the sale of new and used trucks and service repairs, we expect Truck Investments to register further revenue growth in the next two years.

The stock price of CIL has come down since its earnings announcement, because most investors are worried about the financial burden imposed by its Australian real estate investment. CIL was forced to consolidate the Surfers Paradise office tower into its financial statements as Corporate Equities Ltd., which is 49% owned by CIL and was the owner of the property, failed to meet its financial obligations.

The office tower is currently 50% leased and was recently appraised at \$49 million. It carries a mortgage of approximately \$78 million at 6.5%. The bank that granted the mortgage agreed to capitalize the interest until March 1995. The annual interest expense associated with the office tower is only \$5 million, and by the time cash interest payment begins, CIL will have only one more coupon payment to make on its 13.5% convertible notes. Once the convertible notes mature, CIL can save \$6.75 million interest expense each year.

Therefore, it is our opinion that the impact of taking over the office tower on CIL's financial position is not as damaging as many investors believe. We projected its fiscal 1995 interest expense to rise slightly to \$12.4 million from \$10.2 million this year. It should peak at \$15.5 million in fiscal 1997. Nevertheless, these figures are already far lower than the interest expense of \$17.4 million and \$22.7 million in fiscal 1993 and 1992, respectively.

Furthermore, despite the trend of higher interest payment in the next few years, the strong EBIT growth of its core businesses will more than offset the rise in interest expense,

thus allowing bottom line growth. Our projected fiscal 1995 EBIT is in the area of \$24 million, a 16% increase over fiscal 1994. This should translate into a net income of \$6.9 million.

Our financial analysis above indicates that the default risk on the 13.5% convertible notes is very small, since CIL has strong operating cash flow that almost certainly can cover the remaining two coupon payments. In addition, its stock should continue to decline because of the expected dilution upon the capital notes' conversion in June 1995. At a price to EBIT multiple of four, our six-month target price of CIL's common shares is approximately 18.5¢ per share on a fully-diluted basis. In that case, each convertible note should be allocated five shares, which is the maximum set by CIL. With redemption at 92% of face value, the convertible notes offer investors an extremely attractive yield to maturity of 31.4% at the current price.

STRATEGY: *We believe CIL's convertible notes still provide an unusually attractive yield at the current price level. The high potential return from the notes as well as from the strong New Zealand dollar far outweighs the limited risk as discussed above. We rate these notes a strong buy for risk-conscious accounts.*

TWA attempts restructuring

Security: 10% Senior Secured Notes

Maturity: November 3, 1998

Recent price: \$54.85

Yield to maturity: 30.1%

TWA announced its restructuring plan on October 13, after completing the negotiations with all three unions on work-rule changes and benefits reduction. The agreement reached with the flight attendants' union has yet to be ratified.

Similar to the rumor previously circulating in the market, the essence of the restructuring plan is a massive debt/equity swap. TWA proposed that various creditors of the company give up part of their claims and in return receive common stock. The argument is that the restructured TWA should have a much lighter debt burden and a competitive cost structure. As a result, TWA should generate healthy profits post restructuring and the common stock should be worth much more than what it is today.

We have summarized in the following the key aspects of the restructuring plan (the plan).

- 1) Exchange offer for the outstanding notes:
 - a) For each \$1,000 in principal amount of the existing 10% senior secured notes, TWA is offering \$337.50 in face value of new 10% notes due 2003, 29.4 shares of common stock and 7.35 equity rights. The new 10% notes will have the same collateral as that of the existing 10% notes. Each equity right will allow the holder to buy one TWA common share at a 40% discount to the average closing price of the first fifteen trading days after the exchange starts.
 - b) For each \$1,000 in principal amount of the existing 8% secured notes, TWA is offering 21.97 common shares and 5.49 equity rights. The equity rights have the same features as described above.

For both the existing 10% and 8% notes, acceptance of at least 85% in principal amount is required to effect the plan.

2) Amendments to current indentures of the 10% and 8% notes: TWA is asking for the noteholders' consent to change the current indentures. The essence of the proposed changes is to release all collateral underlying the 10% and 8% notes and remove most covenants. The purpose of this proposal is to leave those noteholders who reject the plan with subordinated and unsecured notes, the value of which will be drastically lower than what they are now. This is a means to entice noteholders to accept the plan because if enough noteholders vote yes, those who reject it will run the risk of being left with notes that become unsecured. (Those who accept the plan will no doubt agree to the indenture amendments.) The consent of more than 50% of the principal amount is required.

3) Exchange offers to holders of other indebtedness: TWA is offering other creditors, including the Pension Guarantee Benefit Corp., a total of 12.86 million common shares and 3.2 million equity rights in exchange for debt forgiveness amounting to \$294.4 million. Consent of all these parties is necessary to effect the plan.

4) Offers to flight equipment lessors: TWA is offering the lessors of its leased flight equipment (mainly aircraft) a total of up to three million common shares and 753,717 equity rights in exchange for forgiving three months' rentals. In addition, TWA is proposing to defer another three months' rent payment. The deferred rentals will be paid in equal instalments over the life of the various leases plus 10% interest. A minimum of \$85.8 million rental moratorium is required to effect the plan.

5) Recapitalization of preferred stock: TWA is proposing to exchange each existing preferred share for 0.0444 shares of common stock, 0.0111 equity rights and 0.0786 warrants. The exercise price on the warrants is not yet decided. The consent of at least two thirds of existing preferred shares is required.

6) Amendments to Certificate of Incorporation: TWA is asking for the common shareholders' consent to amend its Certificate of Incorporation so that the company will be authorized to issue up to 137.5 million common shares. Also, TWA is proposing a one-for-10.6519 reverse split of the existing common shares. Acceptance from more than 50% of outstanding common shares are required.

If the plan is executed, TWA will have to issue additional common stock of up to 43 million shares post reverse split. With the currently outstanding 845,000 shares (20 million shares before reverse split), TWA will have 43.9 million shares outstanding. However, if all the equity rights and warrants are exercised, the total shares outstanding will rise to approximately 59 million. After the restructuring, the equity distribution will look like the following:

Unions	30.0%
PBGC	21.2%
8% noteholders	15.6%
10% noteholders	13.9%
Non-union shareholders	7.0%
Lessors	6.4%
Other creditors	5.9%
<hr/>	
Total	100%

Comment

Our analysis shows that TWA's offer to both the 10% and 8% noteholders is grossly inadequate. The 10% noteholders will

receive only 37¢ face value of new 10% notes per dollar of old notes. The rest will be in equity. The 8% noteholders, on the other hand, will only get stock and equity rights.

Since our main holdings are the 10% notes, our discussion of the plan will center on them.

TWA is selling the plan to the 10% noteholders on two arguments (the selling points to the 8% noteholders are largely the same). The collateral that most investors believe is very valuable is in fact worth much less. And a deleveraged and lower-cost TWA will make healthy profits, which means the equity will be worth a lot more.

TWA and Salomon Brothers estimated the recovery rate for the 10% notes to be 75% under the plan, assuming a post-restructuring stock price of \$13 to \$14 per share (market cap of \$700 million) and the new 10% notes trading at par. The \$13 share price is based on the assumptions that TWA will produce a net profit of \$1.5 per share in 1995 and the stock will trade at nine times earnings.

We believe their price assumptions of the stock and new 10% notes are highly questionable. However, the most controversial point, and it is also the point we as bondholders are most concerned about, is the collateral's value. TWA told us at the securities holders' meeting that a recent independent appraisal by SH&E Inc. put the value of the collateral underlying the 10% notes (landing slots, spare parts, planes and engines, and the LAX hanger) at \$85 million on a liquidation basis. This is dramatically lower than the \$230 million to \$250 million most investors used in their analysis, which was given by the previous appraiser Avmark Inc. during the Chapter 11 proceedings. Avmark has recently said that they believe the value of the collateral should have little changed since their last appraisal.

The management of TWA failed to explain why the collateral's value has declined so much in only one year. While SH&E Inc. may be a respected appraisal firm, we are eager to find out what assumptions were used to arrive at the appraised value. We were told by Shawmut Bank, the trustee of the 10% notes, that one assumption they used is that all collateral has to be sold in six months, which we believe is totally unreasonable. For a liquidation of the size of TWA, a 18- to 24-month liquidation period should be the minimum required to realize fair value of the collateral.

We believe the analysis of the plan should be divided into two phases. The first phase is to find out what the true fair liquidation value of the collateral is. Shawmut Bank has hired an independent appraisal firm to study this issue. In addition, TWA is arranging for SH&E Inc. to explain to bondholders how they arrived at the appraised value.

The second phase is to analyze TWA's business plan, financial projections and equity valuation to see how realistic they are. However, if the collateral's true liquidation value is found out to be much closer to our previous estimate, which we believe should be the case, phase two becomes unnecessary. The reason is that the future equity value depends on too many uncertain factors (industry conditions, general economy, oil prices, TWA's management capabilities, political environment, etc.). If we can achieve a good return by selling the collateral, we should not hesitate to demand liquidation.

We are working with the trustee of the 10% notes, its legal and financial advisors, and other major noteholders to formulate a detailed analysis of and response to TWA's proposal. Since TWA intends to move quickly in its negotiations, we can expect some significant development in the coming one to two months.

An examination of the overall plan tells us that TWA should find it extremely difficult to convince all creditors to accept the plan. Not only is the offer to the 10% noteholders totally inadequate, their offers to the 8% noteholders and preferred shareholders also are far from acceptable. Besides, their debt/equity swap proposal to the PBGC will likely be turned down, as PBGC historically has been very reluctant to take an equity instead of secured debt position for pension liability.

Therefore, we believe that the chance of the plan being approved is close to zero, unless TWA substantially improves their offers to various creditors. Our initial conversation with

some major noteholders indicates a high degree of consensus in this regard.

STRATEGY: Based on the current offer laid out by TWA, we do not recommend any 10% noteholders accept the plan. We believe the collateral's true liquidation value is much higher than TWA's estimate, and will give noteholders a recovery rate well above 75%. Therefore, we are prepared to demand liquidation if there are no better alternatives. This will mean an interesting battle between the noteholders and TWA. Stay tuned for more updates.

— Edison Lee

**Chart 15
FOREIGN CURRENCY BONDS**

DATE: October 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% 7/5/95 RRSP	98.85	99.7	5.81		May-07
World Bank 5 7/8% 4/02/97 RRSP	99.5	100.45	5.64		Feb-04
World Bank 9% 13/11/00 RRSP	109.7	110.55	6.81		Nov-13
Kingdom of Denmark 6 1/8% 15/04/98	97	97.85	6.83		Apr-15
Argentina 8% 5/10/98	98.65	99.5	8.15		Oct-05
Bk. Foreign Eco. Affairs 7% 29/3/96	90	90.85	14.49		Mar-29
Kgdm. of Spain (Floating) 29/6/02 (semi)	99.11	99.41		4.9375	Dec-29
FINNISH MARKKA DENOMINATED BONDS					
Rep. of Finland 11% 15/6/95	102.05	102.9	5.98		Jun-15
ITALIAN LIRA DENOMINATED BONDS					
Nordic Inves. Bk 12 3/8% 19/04/96	101.5	102.35	10.46		Apr-19
General Electric 11 1/2% 7/02/95	99.65	100.5	8.90		Feb-07
SWISS FRANC DENOMINATED BONDS					
General Electric 4 3/4% 2/7/98	96.9	97.75	5.43		Jul-02
DANISH KRONE DENOMINATED BONDS					
Kgdm. of Denmark 9% 15/11/96	101.45	102.3	7.76		Nov-15
ECU DENOMINATED BONDS					
United Kingdom 9 1/8% 21/02/01	102	-	-		Feb-21
BRITISH POUND DENOMINATED BONDS					
Kgdm. of Sweden 8 3/4% 29/5/96	100.40	-	-		May-29
FRENCH FRANC DENOMINATED BONDS					
Credit Lyonnaise 9 1/2% 23/12/96	103.55	104.4	7.20		Dec-23
JAPANESE YEN DENOMINATED BONDS					
World Bank 5 3/4% 7/6/96 RRSP	103.45	104.3	3.21		Aug-07
CANADIAN DOLLAR DENOMINATED BONDS					
Ontario Hydro 10 7/8% 8/01/96 (semi)	103.25	104.75	6.56		Jan-08
Eksportfinans 7 3/4% 5/11/97	97.55	-	-		Nov-05
Royal Bank of Canada 9 1/8% 7/1/97	100.6	-	-		Jan-07
SOUTH AFRICAN RAND DENOMINATED BONDS					
ESCOM 12% 1/5/96 (semi)	95.55	96.4	14.77		Nov-01
AUSTRALIAN DOLLAR DENOMINATED BONDS					
Commonwealth Bk. of Australia 9 3/4% 15/5/96	101.00	-	-		May-15
TURKISH LIRA DENOMINATED BONDS					
Government of Turkey T-Bill 15/11/94	92.94	-	-		Matures Nov-15
NEW ZEALAND DOLLAR DENOMINATED BONDS					
New Zealand Gov't 10% 15/7/97 (semi)	102.75	103.6	8.48		Jan-15
Fletcher Challenge 10.75% 15/12/97 (semi)	99.35	100.20	10.66		Dec-15
Fletcher Challenge 10.15% 30/11/98 (semi)	97.3	-	-		Nov-30
Corporate Investment Ltd. 13 1/2% 19/6/95 (semi)	81.85	84.35	31.44		Dec-19
Tranz Rail Ltd. 10% 15/10/99 (semi)	96.2	97.05	10.78		Oct-15
DB Group 7% 30/6/96 (semi) matures @ 85	84.5	85.35	8.35		Dec-30
ARGENTINEAN PESO DENOMINATED BONDS					
BIC V Fixed/Floating 1/5/2001 Callable in full on every interest date	76.35	77.2	14.19		4th day of mth.
U.S. DOLLAR DENOMINATED FIXED CONV. BONDS					
Datapoint Corp. 8 7/8% 1/6/06 CV@18.11psh (semi)	37.75	39.25	25.24		Dec-01
Burnap & Sims 12% 15/11/00 CV@16.79 psh (semi)	93.25	94.75	13.29		Nov-15
Atari Corp. 5 1/4% 29/4/02 CV@18.31 psh	66.25	67.75	11.99		Apr-29
Coeur D'Alene 6% 10/6/02 CV@ 26.00 psh	93.25	94.75	6.90		Jun-10
Glycomed 7 1/2% 1/1/03 CV@14.06 (semi)	50.25	51.75	19.55		Jan-01
California Microwave 5 1/4% 15/12/03 CV@28.44 psh (semi)	110.25	111.75	3.72		Dec-15
U.S. DOLLAR DENOMINATED FIXED RATE BONDS					
Farm Credit Corp 7 3/4% 10/06/96 RRSP	101.05	101.9	6.44		Jun-10
T.W.A. 10% 3/11/98 (semi)	53.75	54.6	30.26		Feb-01
U.S. DOLLAR DENOMINATED FLOATING RATE NOTES					
Kgdm. of Denmark 25/3/97 (Gold call, JY put), (semi)	98.5	99.5		5.84	Mar-25
United Kgdm. 30/9/96 3 mo. LIBID-1/8 (qty), callable @100	99.75	100.05		5	Dec-30
Boccon 1/4/01 (30 day LIBOR) starts accruing May 1, 1997	86.45	87.3	12.71		May-01-97
Argentina: Series L.FRB 31/3/05, 6 mo. LIBOR+13/16 (semi)	76.625	77.375	11.63	6.5	Mar-31

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

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

RECOMMENDED CURRENT PORTFOLIO ALLOCATIONS			
1. GOLD/YEN BOND	20%	6. BK. FOR. ECO DM	2.5%
2. SPAIN DM	10%	7. FRB/BIC V	15%
3. CIL NZ\$	5%	8. U.K. FRN	17.5%
4. TRANZ RAIL NZ\$	10%	9. Atari	5%
5. NEW ZEALAND GOV'T	15%		

For further information & current prices please call:
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HOTLINE UPDATE

Flash Update, Friday, September 23, 12:43 pm:

Liquidate long October sugar at the market, presently trading at 12.51, cancelling the previous stop of 10.50, close only.

Friday, September 23:

The following is a recap of this week's recommendation. For Friday, September 23 at 12:43, via flash update, we advised the liquidation of long October sugar at the market, then trading at 12.51, cancelling the previous stop of 10.50, close only.

Friday, September 30:

There are no changes or recommendations.

Flash Update, Monday, October 3, 6:00 pm:

Buy December crude oil at the market; place stops at 16.95, close only.

Tuesday, October 4:

There are no changes or recommendations. The following is a recap of this week's recommendations: Buy December crude oil at the market; place stops at 16.95, close only. December crude oil opened at 18.30 on Tuesday, October 4.

Flash Update, Wednesday, October 5, 9:00 am:

Buy December Canadian dollars at the market, presently trading at .7430, risking .7305 stop, close only.

Flash Update, Wednesday, October 5, 9:20 am:

Liquidate long gold and silver positions at the market, cancelling the stop, close only, of 379.00 and 525.00, respectively. December gold is presently trading at 396.70 and December silver at 566.00.

Friday, October 7:

There are no changes or recommendations. The following is a recap of this week's recommendations.

On Monday, October 3 at 6:00 pm via flash update, we advised you to buy December crude oil at the market; stops were placed at 16.95, close only. December crude oil opened on Tuesday, October 4 at 18.30.

On Wednesday, October 5 at 9:00 am via flash update, we recommended you buy December Canadian dollars at the market. The Canadian dollar was then trading at .7430; stops were placed at .7305, close only. Also on Wednesday, October 5, via flash update, at 9:20 am, we recommended the liquidation of long gold and silver positions at the market, cancelling the previous stop, close only, of 379.00 and 525.00 respectively. December gold was then trading at 396.70 and December silver was then trading at 566.00.

Flash Update, Tuesday, October 11, 8:40 am:

Liquidate January platinum at the market, presently trading at 419.00, cancelling the 403 stop, close only.

Tuesday, October 11:

There are no changes or recommendations. The following is a recap of this week's recommendation. Liquidate January platinum at the market, then trading at 419.00, cancelling the 403.00 stop, close only.

Friday, October 14:

There are no changes or recommendations. The following is a recap of this week's recommendation. On Tuesday, October 11 at 8:40 am via

flash update, we advised the liquidation of January platinum at the market. January platinum was then trading at 419.00; cancelling the 403.00 stop, close only.

Tuesday, October 18:

There are no changes or recommendations.

Flash Update, Thursday, October 20, 8:29 am:

There are three new recommendations:

1. Buy February gold at the market, currently trading at 396.60; place stops at 391.20, close only.
2. Buy March silver at the market, currently trading at 553.00; place stops at 544.50, close only.
3. Add to the existing long cocoa positions and buy March cocoa at the market; place stops at 12.80, close only.

Flash Update, Friday, October 21, 8:25 am:

There are 2 new recommendations.

1. Those in the positions of long Swiss/short yen should cover their short yen at the market, presently trading at 103.50, and remain long the Swiss franc; place stops at .7750, close only.
2. Buy January platinum at the market, presently trading 429.50; place stops at 414.50, close only.

Flash Update, Friday, October 21, 10:05 am:

Buy March sugar at the market, presently trading at 12.82; place stops at 12.40, close only.

Friday, October 21:

This is a complete summary since our last market letter dated September 18, of all liquidations of open positions and new recommendations that remain outstanding.

On Friday, September 23 we advised the liquidation of long October sugar then trading at 12.51.

On Monday, October 3 we advised the purchase of December crude oil at the market, placing stops at 16.95, close only. December crude oil opened at 18.30 on Tuesday, October 4.

On Wednesday, October 5 we advised the purchase of December Canadian dollars at the market, then trading at .7430, placing stops at .7305, close only. We also advised the liquidation of long gold and silver positions at the market, then trading at 396.70 and 566.00, respectively, basis December.

On Tuesday, October 11, we advised the liquidation of long platinum at the market, then trading at 419.00.

On Thursday, October 20 we advised the purchase of both February gold, at the market, then trading at 396.60, and March silver at the market, then trading at 553.00; stops were placed at 391.20 and 544.50, respectively, close only. Also we advised to add to existing long cocoa positions — buy March cocoa at the market; stops were placed at 12.80, close only. March cocoa opened at 13.43.

On Friday, October 21 we recommended that those in long Swiss/short yen positions should cover their short yen at the market, trading at 103.50 and remain long the Swiss franc, placing stops at .7750, close only. Also, we recommended the purchase of January platinum at the market, trading at 429.50, placing stops at 414.50 close only. And we recommended the purchase of March sugar at the market, trading at 12.82, placing stops at 12.40, close only.

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