FRIEDBERG'S

COMMODITY & CURRENCY COMMENTS

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Monetary chaos, or how it is not enough to act tough

Fundamentals support the US dollar, we proclaimed, leaving little doubt in our readers' minds that the rise of the hard money threesome had little substance behind it. Just eight weeks later, we have egg all over our face, as the dollar has fallen to post-war lows against the yen, DM, and Swiss franc.

What happened was so elementary that we have not forgiven ourselves for this grievous loss of opportunity (fortunately, that is all it was, as we never did recommend selling yen or DM).

We attributed the slight dollar weakness in the early part of the year to the Mexican support operation: a case of bungled up leadership, the Treasury's "loss" of its arsenal of foreign currency and the potential for a very large increase in the world's supply of US dollars. We downplayed these factors, as we rightly should have, but in the process lost sight of a far more serious threat to the dollar, namely the announcement to the world that the Fed was first and foremost the guardian of our economy and not the guardian of our money.

We need here to backtrack somewhat. In past issues we have cited Neil Wallace's seminal paper "Why foreign exchange markets are different from other markets" published in 1979, which argued that a floating exchange regime was basically unstable because fiat money exchange rates were indeterminate.

We do not intend to review these arguments (those interested should obtain a copy from the Federal Reserve Bank of Minneapolis quarterly review, fall 1979). We note his conclusion: In the absence of intervention in exchange markets or restrictions on asset holdings, indeterminacy prevails. This follows from the properties of fiat currency, in particular that fiat currency is intrinsically useless and unbacked. Indeterminacy means that there is no specific level or even range that can be considered an equilibrium rate. Exchange rates can vary all over the lot and need not even return to any specific point.

His little-noticed conclusions are of momentous significance to central banks, currency traders and investors.

In the years since, Wallace's conclusions have proven remarkably correct. Two vivid examples of indeterminacy were the US dollar bubble of the mid-'80s and the long and persistent rise of the Japanese yen of the late '80s and through the '90s. The first one was put to an end only after a concerted and very determined intervention effort carried out by the main industrialized countries (part of the Plaza Accord); the second one is still with us, as there is still no consensus to act in a concerted and dramatic fashion.

Broadening Wallace's conclusions somewhat, one may argue that currency markets require, in addition to intervention, a very firm commitment on the part of a central bank to safeguard the purchasing power of its currency. This single-minded determination must be seen to be consistent with the spending and taxing path taken by the other arm of the government, i.e., the treasury. Conflicting central bank goals and/or the unsustainable accumulation of government debt are punishable by capital flight, causing currency depreciation.

The indeterminacy postulate makes hash of purchasing power analytics. How else can one explain the collapse of some European currencies after having relaxed or left in 1992 their tight ERM linkage, to the point that the Italian lira, the Spanish peseta, and the British pound are now trading

In this issue

Contributions by Albert D. Friedberg, Edison Lee and Shalom Sanik.

New Hotline Number

Enclosed with this issue is a card showing our new Hotline Update telephone number. Please use this number to contact our Hotline Update service, effective April 4.

40%, 25%, and 20% respectively undervalued (on some estimates of purchasing power parity) relative to the DM? The first two named currencies have been mauled by the market's perception that their countries' debt growth has taken on an exponential curve, one that will necessarily threaten in due time their monetary integrity. The UK, on the other hand, enjoys a much better fiscal position, but its pound has been severely punished by the lack of transparency and commitment to achieve price stability shown by the Bank of England.

In all these and similar cases (Sweden, Canada) lack of clear and coherent monetary/fiscal policies have vindicated the indeterminacy postulate, as external currency depreciation has raced far ahead of the "fundamentals." (For example, assuming that most or all of the lira overvaluation that led to its initial abandonment of the ERM in the summer of 1992 was corrected by early 1993, one would still be hard put to explain why the lira's trade-weighted index has since dropped an additional 20%. Italy's consumer price inflation for the past two years has exceeded Germany's by a mere 4.6%.)

In the absence of a psychological anchor, this process of external overshooting will continue unhampered by domestic considerations. Eventually the overshooting is vindicated as the *internal depreciation catches up*. Chart 1, is a colorful but very dramatic example of external overshooting (see particularly November, December 1922, and January 1923) and the way domestic prices eventually caught up. Much the same may be happening in Italy, Spain, and the UK where latest three-month inflation rates have begun to accelerate relative to their latest 12 months.

Let us now return to the US dollar. We had argued in January, and again last month, that monetary conditions in the US were becoming tighter, a favorable omen for a firmer dollar. As these conditions have persisted to date, we need only review them to verify this assertion.

Charts 2 and 3 show an accelerating rise of bank loans funded, in the absence of monetary accommodation, by a draw-down of securities holdings. Total bank reserves have been flat for the past six months and are down 2.5% from a year ago. Rising rates of course have caused funds to migrate from reservable checking deposits to non-reservable time deposits allowing for some expansion of total credit even on unchanged reserves. Nevertheless, the total picture is one of monetary stringency; the banking system as a whole continues to lose some of the extraordinary amounts of liquidity that it had gained in the 1990-93 period.

This glacial tightening — more the market's doing than the Fed's — can also be observed by the flattening of the yield curve (see Chart 5). If not outright tight, the Fed has at least not accommodated the sizzling pace of bank loans. Coupled with some eye-opening gains in relative competitiveness (see Chart 6), and the indisputable fact that the American public's infatuation with the emerging markets has come to an end (and that capital is thus being repatriated), a good case could be made (and was made) for a US dollar recovery.

What really turned sentiment against the dollar were declarations made, within days of each other, by the two most important Fed officials. In a speech to the Bond Club in Virginia on February 17, Fed Vice-Chairman Allan Blinder expounded that the logic of a preemptive strike strategy "cuts both ways," and cautioned that "the majority of effects" of the rate increases already put into force by the Fed "are still to come."

He said the Fed was correct to launch its preemptive attack on inflation last February, but added pointedly that "when you embark on a course like that, you should know when to stop and be prepared to make a preemptive strike against recession as well." On February 23, Chairman Allan Greenspan, making a semi-annual appearance before the House Banking Committee panel on Monetary Policy as required under the Humphrey-Hawkins Full Employment and Balanced Growth Act, confirmed, in as many words his Vice-Chairman's observations. He said, "because the effects of monetary policy are felt only slowly and with a lag, policy will have a better chance of contributing to meeting the nation's macro-economic objectives if we look forward as we act, however indistinct our view of the road ahead.

"Thus, over the past year, we have firmed policy to head off inflation pressures not yet evident in the data. Similarly, there may come a time when we hold our policy stance unchanged or *even ease, despite adverse price data*, should we see signs that underlying forces are acting ultimately to reduce inflation pressures."

The Fed was showing its true colors: Monetary policy was being used as an instrument to modulate/fine tune economic growth. The fight against inflation was being abandoned prematurely lest the country fall into a recession. Not coincidentally, the dollar began to fall with the dissemination of Blinder's speech. The fall gathered steam no sooner than Allan Greenspan's testimony became public.

More than one year's worth of tightening went out the window, aided and abetted by the pointed remarks of the two most important Fed officials that the fight against a possible recession takes precedence over the fight against inflation. The market perceived the ambiguity of the Fed's position and its lack of commitment to safeguard the purchasing power of the dollar. Indeterminacy would see the dollar drop well below rational valuation yard-sticks.

Under the indeterminacy postulate there is no reason why the dollar should not fall to 85, 80, 75, or 50 yen, or why the Swiss franc and the DM should not attain parity with the US dollar. Recurrent bouts of intervention, as we have seen for the past few weeks, are not enough. It may now require another significant notching up of rates (and perhaps an inverted yield curve) and/or a categorical statement by the G-7 that they are not prepared to see the dollar go lower accompanied by a very powerful and concerted support operation.

Since February 17, the dollar has fallen 8.7% against the yen, 6.8% against the Swiss franc and 4.8% against the DM. This loss of opportunity is the price for taking our eyes off the ball in a market that will not by definition play by fundamentals. We hope not to repeat this error.

STRATEGY: *Traders should be prepared to go long Japanese yen and Swiss francs. A point of entry will be provided over the hotline.*

Long-term investors should be sure to position a substantial portion of their fixed income portfolio in New Zealand dollar-denominated securities. The Reserve Bank's attention to the Kiwi's trade-weighted level should guarantee Kiwi holders a significant appreciation against the US dollar.

Add to previously established June '95 Eurodollar short positions and/or put options (see Hotline Update of March 7).

Chart 1

Depreciation of the mark 1922-23

		Dollar rate	Internal prices
1922	July	100	100
	August	230	177
	September	297	276
	Occtober	645	533
	November	1456	1018
	December	1539	1371
1923	Januaary	3644	2553
	February	5661	5280

Source:Bresciani-Turroni

Chart 2

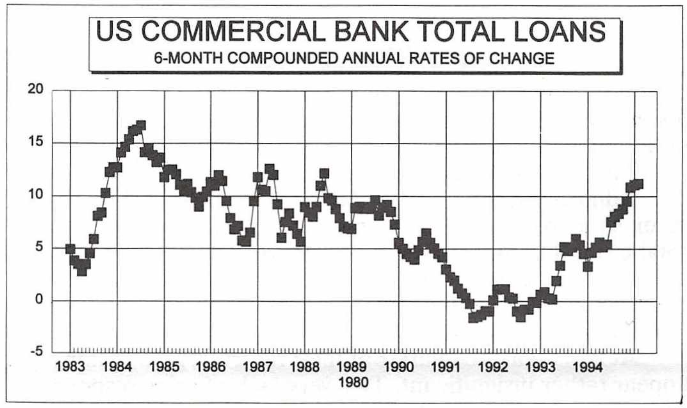


Chart 3

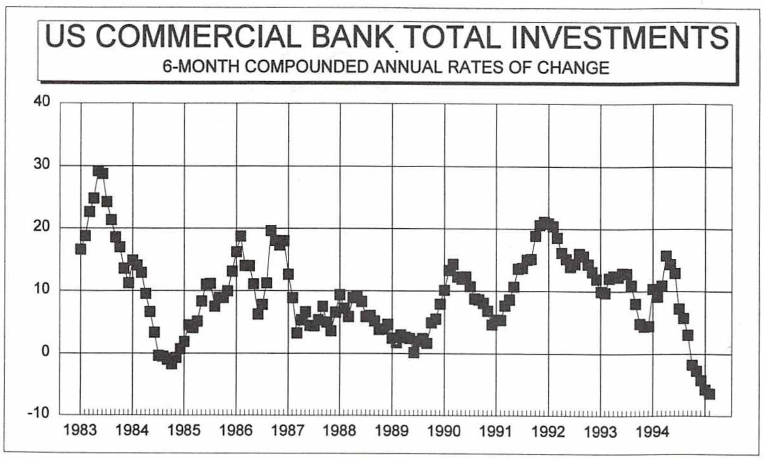


Chart 5

F A I R   M A R K E T   Y I E L D   C U R V E S

	#1	#2	#3	#4
3MO	5.82	5.68	4.22	3.07
6MO	6.06	6.49	4.81	3.29
1YR	6.28	7.16	5.48	3.58
2YR	6.63	7.69	6.17	4.23
3YR	6.73	7.78	6.47	4.51
4YR	6.82	7.80	6.71	4.86
5YR	6.91	7.83	6.95	5.20
7YR	6.92	7.83	6.97	5.34
10YR	7.08	7.83	7.32	5.79
20YR	7.22	7.85	7.46	6.07
30YR	7.36	7.88	7.61	6.35

#1 = 3/24/95 : ACTIVE GOVERNMENTS
#2 = 12/30/94 : ACTIVE GOVERNMENTS
#3 = 6/30/94 : ACTIVE GOVERNMENTS
#4 = 12/31/93 : ACTIVE GOVERNMENTS

Bloomberg

Chart 4

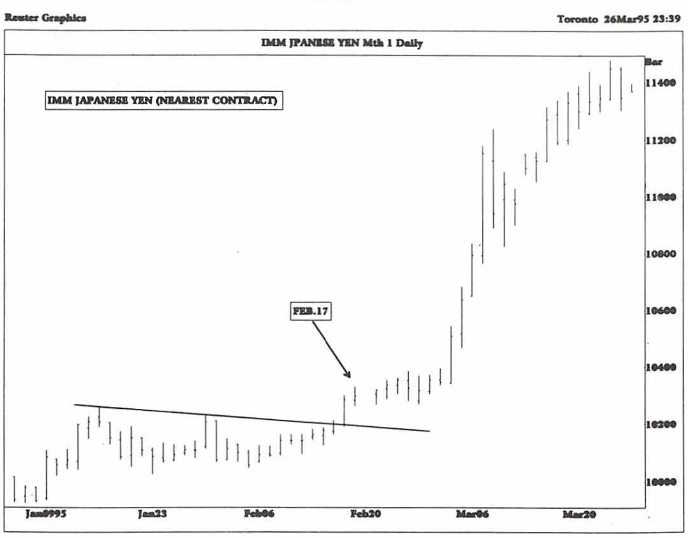
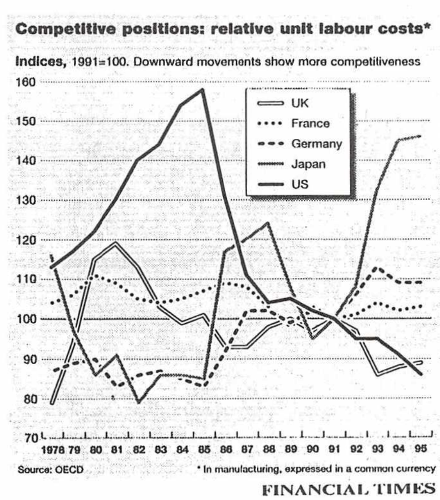


Chart 6



GOLD

The real case for gold

Gold's tepid response to the dramatic fall of the US dollar has convinced the bears that a) gold has finally and for all times lost its monetary value and b) it is thus not likely to reflect the dollar's depreciation.

They are probably wrong on both accounts.

Admittedly, gold has steadily been demonetized. In just seven short years, gold (at market prices) as a proportion of total Central Bank reserves has fallen to 22.8% from 38.9%, a dramatic testimony to the dollar inflation that has taken place since 1987 and bullion's miserable price performance. (And some central bank sales.)

At less than one quarter of their reserves, gold holdings appear rather insignificant. This very lack of price response has reinforced Central Bank bureaucrats' loss of interest in the precious metal. Reacting as any other human being would, they have largely ignored the most unglamorous of all assets and have concentrated instead in building up paper assets, hard currencies, and interest-bearing US dollar securities. Of note is that their combined sales of more than 1,100 tonnes in this span have helped fill in the yearly production deficit.

Should gold prices remain depressed and unresponsive to dollar weakness, one would expect demonetization to continue, partly by central banks' merely ignoring gold's role in international reserves and partly by attrition. Weakness begets weakness. If Central Bank bureaucrats are to begin paying attention to gold once again, gold must wake up from its lethargy and show some strength. In a static model, the demonetization argument enjoys strong credibility. In a dynamic model on the other hand, the demonetization process can stop and even be reversed thus adding strength to strength.

At this point one is hard put to draw any conclusions.

The other fundamentals, however, are much clearer. The fall in the dollar and the consequent "cheapening" of gold has had a significant impact on demand: gold consumption in developing countries monitored by the World Gold Council showed a year-on-year rise in the final quarter of 1994 of 19% thanks to strong growth in India and China (both up 24%). Developed country fourth-quarter demand was up 8% to its highest level in five years.

At the same time, world mine production rose only 1% last year, the lowest percentage increase for more than a decade. The dramatic increases in production of the last 15 years, spawned by the equally spectacular rise of gold in the late '70s, have now come to an end. And with this phenomenon, we should begin to see an end to new forward sales initiated by the owners of new mines being brought into production. In fact, it is not unreasonable to suppose that net forward sales will begin to diminish, reversing their heretofore bearish impact.

Investment demand for the past few years has been dormant, first because of the circular reasoning that gold has been weak. And secondly, because inflation watchers have argued, rather successfully, that barring an unforseen acceleration of inflation, interest-yielding instruments are a more attractive investment. The argument is supported by the fact that gold has underperformed financial assets for more than 15 years. Again, weak markets beget more weakness.

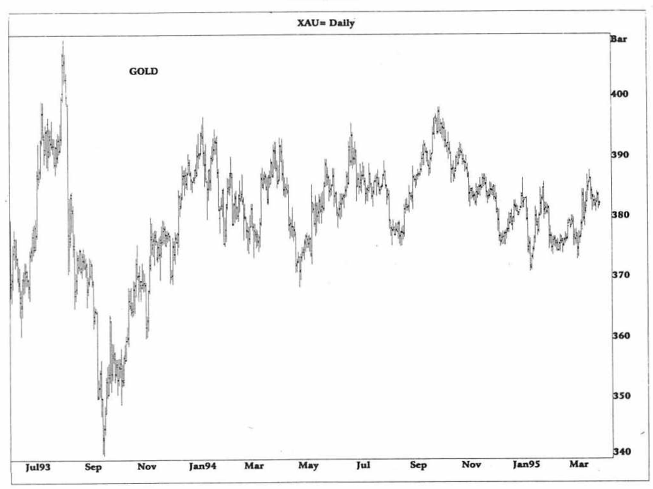
Interestingly, the currency markets have demonstrated that monetary assets need not follow current inflation. This has been true in the case of a number of European currencies (see our lead article), where the market has begun to discount substantial future inflation, even though consumer prices appear relatively well behaved at this time. There are only three standouts (yen, DM, Swiss franc) to the spreading rejection of paper money. If gold begins to act better, will investors begin to discount far-into-the-future inflation?

The case for gold is thus based on the genuine growth of demand and stagnating mine production. The *real* case for gold, on the other hand, will only manifest itself once the market begins to show some strength. Above $420/oz, central bank bureaucrats will begin paying attention and perhaps think of replenishing their lowly gold holdings; producers will scramble to reduce their net forward sales; investors may consider gold's positive returns; and speculators will ignore current price stability and will begin to discount the monetization of trillions of dollars of debt.

STRATEGY: *You are long again, as per Hotline Update of March 13. Also, be sure to own ridiculously cheap call options. But no matter what you do now, be sure to jump on the bandwagon once the market has cleared the $415-$420/oz. level.*

Chart 7

Chart 8



COMMODITIES

Sugar: still a tight market

The past few weeks have seen a steady stream of bearish supply-side fundmentals scroll by on the wire services screens. Vitrtually every sugar statistician, including the USDA, agrees that the 1994-95 production/consumption deficit is much smaller than previously thought and that the 1995-96 season will see the first surplus in four years.

The World Bank, in its quarterly review of commodity markets, states: "The market fundamentals are not especially bullish — growth in world sugar consumption is stagnant, stocks are adequate, and trade levels are declining. World consumption has grown only 0.6% a year since 1990, down from 2.05% during the 1980's."

Not only are the robust Brazilian and Indian crops creating this rosy picture, but even sad-sack Cuba with its paltry 3.5 million ton crop can be optimistic about the future with foreign investment pouring into the country. It's been said that fertilizer is being applied for the first time on fields that have gone without for years, raising hope for improved Cuban yields.

Other than the fact that the projections for the 1995-96 crops are for plants that in most cases are not even in the ground yet, we do not take issue with the general outlook for good crops. Hoping for bad weather has never proven to be a clever trading strategy.

The action in the physicals, however, reveals a different story. The sugar freight market is in disarray. Traders in both eastern and western hemisphere arenas are having difficulty securing adequate shipping to get their sugar to its destination. Ships needed to transport sugar are unique amongst commodity carriers because they require dehumidfying systems to keep the sugar dry. The current fleets are dwindling, and those in operation are aging. There is no known plan for alleviating this situation. Just in the past month the voyage rate in the far east has risen by more than 25%, to $23 per ton.

As a result of this burgeoning problem, the premiums being paid for prompt delivery have skyrocketed. Thai raws are being quoted as much as 250 basis points over the New York May contract, while Brazilian and Cuban sugars are going for previously unheard of 50 points over.

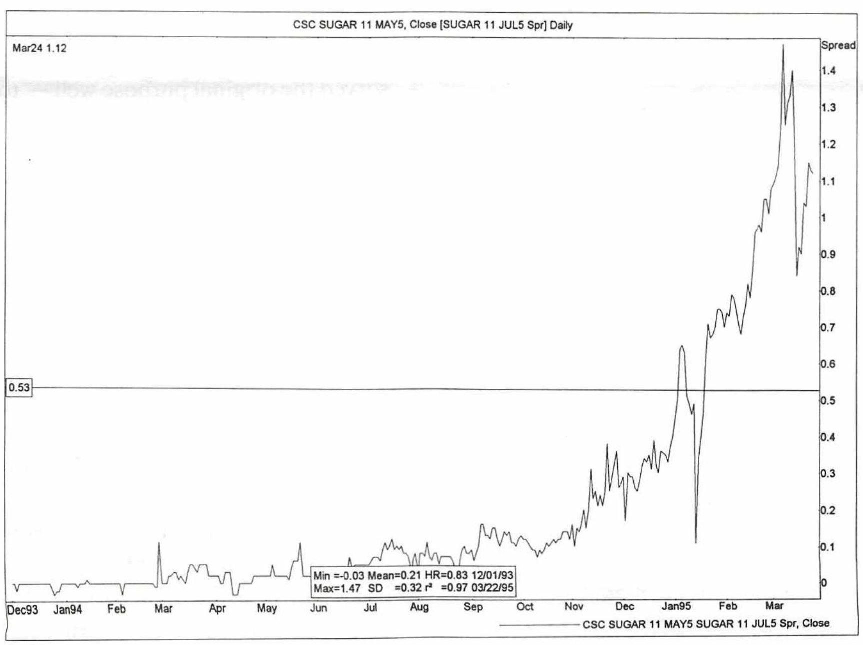
Drawing an analogy from very recent history can perhaps illustrate the dangers of underestimating the power of a true bull market. The price of cotton has more than doubled in the past two years. During the rise, the story being passed around was that the high price was enticing producers to increase their acerage and that a huge new crop would be available for the coming season. The bears were out in full force. Well, just in the past six months spot cotton has gone up about 70% to prices not seen since the American Civil War. The dynamics of short-term, pent-up demand were no match for projections of future record crops.

Similarly, the backwardation in our sugar market just won't go away. We've dropped more than one and a half cents from the highs, but the May/July spread has dropped just 37 basis points from its high to a still very formidable 110 points (Chart 9). True, the crops look good, and someday we might satisfy the market's needs, but for the moment the balance of evidence suggests a tight market.

STRATEGY: *Remain long, with new stops at 13.75, basis May '95, close only.*

– Shalom Sanik

Chart 9



FRIEDBERG CAPITAL MARKETS

The case for Mexican treasury bills (Cetes)

The economic adjustment is proceeding a great deal faster than anticipated. Collapsing imports, a result of the economic recession, have already produced the first trade surplus in four years (see Chart 10). The real exchange rate of the peso has fallen to extreme levels (see Chart 11), and some real appreciation is in prospect. This means that henceforth consumer prices will rise faster than the nominal depreciation of the peso.

In the two previous devaluation episodes (1981-82 and 1985-86), more than 50% of the initial depreciation was reversed in the following three years. Since Cetes are auctioned off weekly, with maturities of 14 and 28 days, we are confident that interest rates will be highly sensitive to the pace of inflation, continuing to yield positive rates in the order of 20% to 25 % per annum.

Combining the two effects — a real appreciation and positive interest rates — Cetes buyers should be able to earn 30% to 35% per annum in US dollar terms.

Chart 10

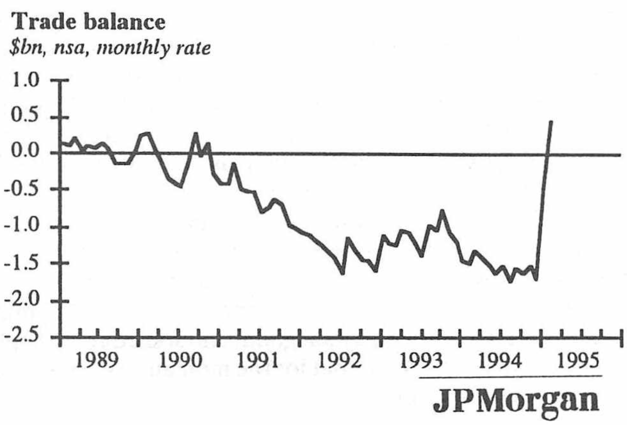
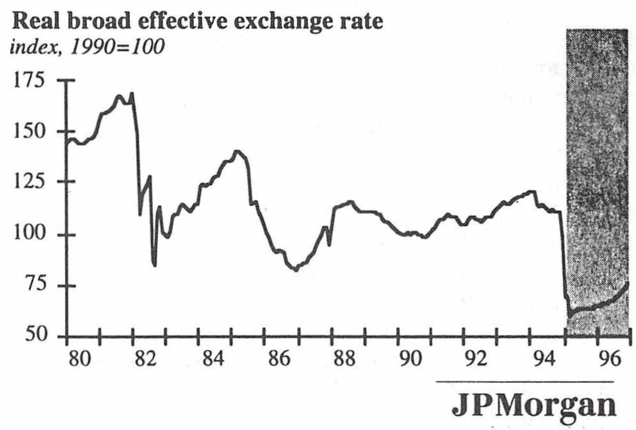


Chart 11



FRIEDBERG CAPITAL MARKETS

Gold Bull/Yen Bear Notes

Issuer: Kingdom of Denmark
Security: Floating-rate note due 1997
Current coupon: 8.45%
Current yield: 11.3%
Recent price: $74.5

Since its introduction in March 1994, the gold bull/yen bear notes have weakened in price mainly because of the substantially stronger Japanese yen against the US dollar and the stable gold price. However, we believe that at the current price level and coupon rate, the notes present an excellent opportunity to capitalize on the expected bull market in gold and the ultimate fall in the value of the Japanese yen.

The latest coupon rate, for the period from March 1994 to September 1994, was recently set at 8.45%. This is substantially higher than the last coupon rate of 5.84% and the initial coupon rate of 3.02%. The reason is that the Japanese yen has strengthened against the US dollar by approximately 20% since the issuance of the notes. The yen's strength has caused the spread of US interest rates and Japanese interest rates to widen. Since the coupon rate is a function of such a spread, it has moved higher. Hence, the coupon rate structure has served the original purpose well — to hedge against a continuously strong yen against the dollar.

At the current price level and latest coupon rate, the notes provide a high current yield of 11.3%. Moreover, the downside risk of the notes has become much smaller given the excessively high value of the yen and our continued bullishness on gold (see our analysis of the gold market elsewhere in this issue).

A realistic downside risk assessment can be made by assuming a flat gold price ($400 per ounce) and the yen going up to the limit imposed by the notes (73.72 yen per dollar) at maturity. The redemption value of such a scenario will be 41.85 cents per dollar. However, the exchange rate at 73.72 yen per dollar represents another 20% appreciation of the yen, which means the coupon rate should continue to rise over the life of the notes. If we assume the coupon rate increases in a linear fashion and reaches 10% for the last period, the nominal loss on the notes will be approximately

19%, or an annualized negative return of 11.1%.

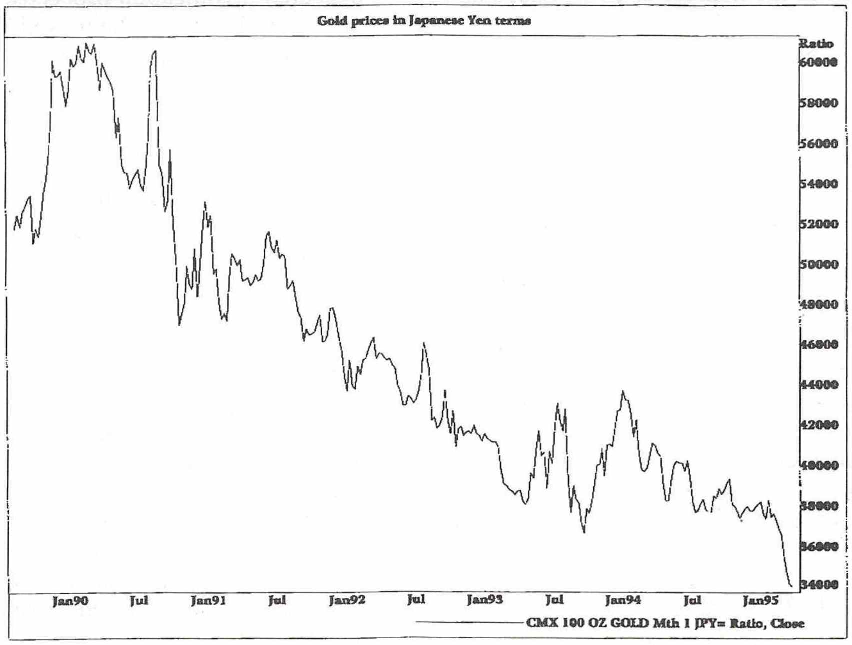
A more reasonable scenario is one in which the yen weakens back to the level of 110 yen per dollar and the gold price moves slightly higher to $450 per ounce by 1997. In this case, the coupon rate should decline during the life of the notes. If we assume the coupon rate falls back to 6.1% (assuming 10 basis points for the spread factor) in a linear fashion, the notes will provide an annualized return of 29.2%, or a nominal total gain of 62%.

In the more bullish scenario, which we originally envisioned, the yen falls substantially to the level of 140 yen per dollar, and gold shoots up to $600 per ounce. In this case, the coupon rate should fall further and it may reach as low as 6%, which reflects only the LIBOR component. The annualized return under these assumptions will be approximately 57%, and the nominal total gain will be 137%.

STRATEGY: *Given our current outlook on gold and the success in the coupon rate structure as a partial hedge against the strong yen, we believe the downside risk of the Gold Bull/Yen Bear notes at the current price level and coupon rate is small. However, the upside can be substantial even based on very conservative assumptions of gold price and the yen/dollar exchange rate at maturity. Therefore, we believe it serves as an excellent instrument to short the yen and take advantage of a strong gold market over the next two years.*

– Edison Lee, CFA

Chart 12



FRIEDBERG CAPITAL MARKETS

Banco de Galicia

Security: 7% convertible subordinated debentures due 2002
Recent price: $57
Yield to maturity: 17.66%
Current yield: 12.3%
Conversion price: $8.67 per share
Recent stock price: $3.55 per share (Buenos Commercial Exchange)
Market capitalization: $487 million

Company profile

Banco de Galicia ("Galicia") is the largest private commercial bank and the third-largest bank in Argentina with total assets of 4.8 billion pesos (one Argentine peso = one US dollar) and a deposit base of 3 billion pesos at the end of 1994. The other three largest private commercial banks are Banco Rio, Banco de Credito and Banco Frances. The top two largest banks in Argentina are both government-owned.

At the end of September 1994, Galicia operated 172 full-service branches across Argentina and had 5 branches in Uruguay. Its branch network is the largest among private commercial banks in the country. Galicia's market shares of loans and deposits in the Argentine banking industry were 5.4% and 5.2%, respectively.

Galicia is mainly engaged in commercial banking activities. It provides general banking services to retail and corporate customers. The amount of consumer loans, including mortgages, has grown exponentially since the Argentine government implemented the Convertibility Plan (fixing the exchange rate at one peso to one US dollar) in April 1991. The proportion of consumer loans has grown from 4.5% of the total loan portfolio in 1991 to over 25% in 1994. On the other hand, corporate loans have also grown by more than four times over the same period. The total loan portfolio has ballooned from 529 million pesos to 3.6 billion pesos, which represented a 590% increase.

In corporate banking, Galicia has been serving mainly medium-sized companies. The bank currently has over 17,000 small- and medium-sized business customer accounts and approximately 300 big corporate accounts. The recent trend shows increasing importance of large corporate customers.

In addition to traditional lending and deposit-taking, Galicia also issues credit cards, provides custodial services and electronic banking, and offers investment banking services (mainly to large corporate customers). In the first quarter of 1994, Galicia was the largest issuer of Visa gold cards in Argentina both in terms of the number of cards issued and volume of transactions.

The bank takes deposits and makes loans in both pesos and US dollars. At the end of March 1994, 23.8% of its loan portfolio was denominated in pesos and 76.2% was denominated in US dollars.

Impact of the Mexican debacle

The devaluation of the Mexican peso has caused a widespread selloff in both debt and equity securities of all emerging markets. Argentina has been hit particularly badly because of investors' fear that its fixed exchange rate system may also collapse one day, resulting in huge losses in all peso-denominated assets overnight.

The perceived devaluation risk has prompted investors to pull out of the Argentine stock and bond markets. The Merval Index (stock market) has dropped 29% since the Mexican peso's devaluation, and at one point was down as much as 46%. On the other hand, both peso- and dollar-denominated Argentine government bonds have lost substantial value. For example, the Argentine peso-denominated BIC V bond has dropped 12% in value so far (down 38% at one point), and the dollar-denominated floating-rate bond is down by 26% (down 42% at one point).

The fallout in the stock and bond markets has resulted in significant capital outflow. Under the currency board system, any loss of foreign exchange reserves at the central bank will mean an equivalent shrinkage of money supply (because the monetary base is 100% backed by foreign reserves). Consequently, the credit condition in Argentina has become extremely tight. The call money rate (overnight inter-bank lending) at one point rose to 80%.

The credit squeeze generated a turmoil in the banking sector because it exposed the problems of those financially weak banks in the system. The drop in government bond prices accelerated the problem when banks tried to liquidate their holdings of government bonds to meet their cash requirements, which in turn caused the bond prices to fall further. The potential insolvency of some banks in the system resulted in a small-scale bank run. We believe a full-scale bank run is the major risk for Argentina because a drastic shrinkage in the monetary base will bring about a depression, which may prompt the government to abandon the currency board in order to reflate the economy. (For a detailed analysis of Argentina's current situation, see "A risk...and an opportunity" in our February issue.)

As we expected, the Argentine government has taken all the right steps to deal with this crisis. It has announced spending cuts of $1 billion and a series of tax increases to generate a budget surplus of $2 billion. It also accelerated structural reforms with the passage of the labor reform laws. The senate approved a bill to restrict pension claims, which ballooned so much last year that it turned the government budget into a small deficit.

All these actions spoke for the government's determination to stick to the currency board system and take the short-term pain of a recession in exchange for long-term healthy growth. It has also won the confidence of the IMF, the World Bank, and other foreign commercial banks by securing a total loan of $5 billion from these institutions. These new facilities, together with the budget surplus and expected privatization proceeds, will provide $10 billion to the Argentine government, well in excess of the $5.2 billion interest and principal repayment due this year.

The new funding has substantially relieved the tight credit condition in the financial system. The call money rate has dropped from a high 80% to around 10%. The short-term liquidity of the banking sector is much improved. Both the stock and bond markets have come back strongly and regained half of their losses. However, we believe that Argentina is not entirely out of the woods yet.

What we expect over the next 12 months are an economic recession, likely to be zero growth versus the government's revised projection of 3%, a rapid consolidation in the banking industry with the weak banks being either merged with the large ones or privatized, and a slow comeback of foreign investors (both direct and portfolio). Longer term, we see a much stronger and healthier Argentine economy as well as banking industry, where only the most efficient banks survive. Management of this crisis has demonstrated the Menem Administration's foresight and its policies have won the approval of most Argentineans. Consequently, his re-election this year is almost assured (based on the most recent poll), which means all the current economic policies will continue.

Galicia's recent performance

Galicia is a major beneficiary of the growth of the entire banking industry following the Convertibility Plan. As the largest private commercial bank and with an extensive branch network, it has seen 600% growth in its loan portfolio and 345% growth in its deposit base between 1991 and 1994. Its market shares in both deposits and loans also increased.

The bank has aggressively expanded its consumer banking business by extending consumer loans such as auto financing and granting mortgages. In respect of corporate banking, Galicia has been very strong in the middle market (small and medium-sized firms). At the end of September 1994, middle market loans constituted 30% of the entire loan portfolio.

The net interest margin of Galicia has declined considerably over the last few years because of the general decline in interest rates in Argentina. For fiscal 1994 (ended June), its net interest margin was 5.57% (Chart 13), which is comparable to that of Banco Frances, another publicly listed Argentine private commercial bank, and those of major US banks. The same chart shows that Galicia's return on assets, while lower than that of Banco Frances, is similar to those of its US counterparts. On the contrary, both Galicia and Banco Frances achieved lower return on equity than average major US banks, which was mainly due to the former's much lower leverage.

Galicia's net interest margin and net income have declined in the last two quarters. Net income for the first quarter of fiscal '95 (ended Sept. '94) was $18 million versus $20 million a year ago, and for the second quarter it was $9 million versus $26 million a year ago. The major reasons were losses from government bond holdings (higher global interest rates have depressed bond prices) and tighter lending spread in the domestic market. The bank has also shifted its lending emphasis to large corporations, which traditionally offer a thinner margin, in order to lower the loan portfolio's overall risk profile.

Prospects of Galicia

The prospects of Galicia over the next three to four quarters will be a function of the Argentine economy. As discussed above, we expect zero growth in Argentina for the next 12 months. The credit condition will still be tight for Latin American companies until investors in developed economies can re-establish confidence in emerging markets in general, and the Latin American region in particular. Such a macro-economic environment, coupled with Galicia's heavy exposure to the middle market and consumer sector, will mean a significant rise in non-performing loans for the bank.

We believe the current loan loss reserve of Galicia does not provide for the anticipated scenario. The loss reserve was 3.27% of total loans at the end of December 1994, which is only marginally higher than the 3.03% and 2.99% at the end of September and June, respectively. Typically, loans made at the late stage of a cyclical economic expansion will have the highest default rate. In the case of Galicia, its loan portfolio has grown dramatically in the last 12 to 24 months, which was also the late stage of Argentina's last economic boom. Consequently, the overall non-performing loans should increase significantly in the next few quarters.

Our estimate indicates that the loss provision (actual loss) may go up as much as 50% compared with the level of fiscal 1994 (June 94). If we assume the loss reserve moves in lockstep with the actual loss, it will mean a loss reserve of close to 4% of total loans, which is much higher than the present level of 3.27%.

Revenue growth of Galicia should also slow down considerably. Loan growth will be stagnant in the current recession, as will be the growth in fee income from consumer (e.g., credit card charges) and corporate banking. However, its net interest margin may expand slightly in the face of generally higher lending rates. A "flight to quality" from smaller banks' customers may restrain the rise in its borrowing cost. The slow revenue growth, significantly higher loan loss, and losses from government bond holdings mean Galicia may suffer a net loss for the next few quarters.

However, longer term, we are bullish about Galicia in the belief that it will emerge as one of the major players in a more mature Argentine banking industry. Its extensive branch network and established customer base should give it a competitive edge in the restructured banking industry. Its higher proportion of fee income relative to its major US counterparts also indicates lower business risk (Chart 13).

We believe there is plenty of room for improvement in Galicia's operating efficiency. Its general administrative expenses as a percentage of revenue was higher than that of Banco Frances as well as those of major US banks (Chart 13). Additional investments in technology should increase efficiency. Moreover, the expected increase in market share due to "flight to quality" may help Galicia achieve more economies of scale.

Valuation and the convertibles

Galicia's common stock has rallied 100% from its post-Mexican-debacle low in the past two weeks. However, it is still 42% below its all-time high. The following table shows the equity valuation of Galicia relative to Banco Frances and the average of five major US banks:

	Galicia[1]	Frances[2]	U.S. Avg[3]
Price to revenue	0.8X	1.88X	1.25X
Price to book	1.13X	1.36X	1.43X
Historical p/e	6.77X	8.12X	9.13X

[1]based on results of the last twelve months ended December '94.
[2]based on results of fiscal 1994 ended June '94.
[3]based on results of the last 12 months ended September '94. The five US banks are JP Morgan, Chase Manhattan, BankAmerica, Wells Fargo, and Chemical.

Galicia's stock is currently trading at a significant discount to its US counterparts and offers substantial long-term appreciation potential. When Galicia emerges as one of the major players in a mature Argentine banking sector following the current recession, its valuation should be much closer to that of the US comparables. At the moment, we agree that Banco Frances is more profitable and efficient than Galicia. However, the lower valuation of Galicia has adequately reflected the difference.

We believe the 7% convertible bond is an excellent alternative to Galicia's stock. The bond is currently trading with a yield to maturity of 17.6% and a conversion premium of 39%. Based on the stock's 2.4% dividend yield, the convertibles' payback period is a short 2.78 years. Since the bond now yields 100 basis points more than the comparable Argentine government bond, its current price reflects only the investment value. We estimated its participation in the stock's upside to be 50%, and 40% in the downside. As the stock should continue to show high volatility in the medium term, especially when the higher loan loss hits its bottom line, the convertible bond is a great alternative to playing Galicia's long-term potential.

STRATEGY: *We expect the banking sector of Argentina to become more mature and solid following the current crisis, and Banco de Galicia should be one of the winners in the industry. The 7% convertible bond is a better alternative than the stock as a play on Galicia because it trades at its investment value and has a short payback period. Despite a strong comeback in the last two weeks, the current price level still offers excellent value for long-term, risk-conscious investors. We rate it a buy.*

– Edison Lee, CFA

Chart 13 – Comparative Statistics of Banks

	Galicia (1)	Frances (1)	JP Morgan	Chase	Bank America	Wells Fargo	Chemical	US Avg. (2)
Net interest margin	5.57%	5.95%	8.89%	5.36%	4.41%	5.43%	4.24%	5.67%
Return on assets	1.54%	3.21%	1.40%	0.72%	1.67%	2.75%	1.47%	1.60%
Return on equity	15.5%	16.8%	22.3%	10.0%	18.9%	35.7%	23.0%	22.0%
Assets to equity	10.0X	5.2X	15.9X	13.9X	11.3X	13.0X	15.7X	13.9X
Fee income to revenue	28.2%	40.4%	21.2%	21.3%	22.9%	24.5%	23.1%	22.6%
SG&A to revenue	47.3%	45.6%	31.7%	37.9%	47.0%	43.5%	41.9%	40.4%

(1) Banco de Galicia and Banco Frances results are for fiscal year ended 6/30/94.
(2) Results of all US banks are for the last 12 months ended 9/30/94.

FRIEDBERG CAPITAL MARKETS

Update on Atari Corp.

Security: 5.25% convertible subordinated debentures
Maturity: April 2002
Recent price: 48.25/49.75
Yield to maturity: 18.5%
Conversion price: $16.3 per share
Recent stock price: $2.75 per share

Atari's 1994 fourth-quarter results showed a 75% jump in sales to $14.9 million and a narrowing of operating loss to $12.6 million from $21.8 million. Owing to the lawsuit settlement with Sega, Atari recorded a one-time gain of $29.9 million in the fourth quarter, bringing net income to $17.6 million. Its full-year operating loss was $20.4 million.

The revenue figure implied the fourth-quarter sales of Jaguar were in the area of 40,000 to 45,000 units. Full-year sales of Jaguar should be between 130,000 and 160,000 units, which were way below the initial estimate of 350,000 to 500,000 units. The slow sales have been due to the limited availability of games. At the moment, there are about 20 to 25 games available, and most stores carry the most popular 10 to 15 titles.

Atari has recently introduced a low-cost package of Jaguar at $149.99 with no games as an alternative to the original $249.99 with one game included. The price cut would certainly hurt Atari's already thin gross margin. We estimated that their gross margin would decline from 17% to approximately 10% if all future sales come from the low-cost package, which is very likely.

We have done an informal survey with major toy/electronics stores in New York and San Francisco. The results indicated that 1) 3DO's 32-bit machine continued to be the best seller, 2) Jaguar's sales had no significant improvement with the moderate number of games now available, 3) Jaguar's graphics are not appreciably better than 3DO's and 4) Sega and Nintendo are expected to come out with new machines this Christmas, which will create intense competition.

Moreover, Time Warner announced recently that it was considering selling its stake in Atari (25%, currently worth approximately $40 million) in order to reduce its debt. While it is not known whether the sale is a reflection of its assessment of Atari's prospects, the loss of Time Warner as a possible lender of last resort has pulled the stock price down by 15%.

Our assessment is that while the current status of Jaguar's sales does not point to bullish prospects, there are some strengths in Atari which should not be dismissed too early. They include: 1) $81 million in cash and a 1.7X asset coverage of the convertible bonds; 2) possible availability later on of more attractive games when software developers can take full advantage of Jaguar's hardware capabilities; 3) the joint venture with Sigma Designs to produce a PC-compatible board for Jaguar's games; 4) the joint venture with Virtuality Group to develop a low-cost virtual reality game system. The PC-board and virtual reality projects should bring about substantial royalty income if they materialize.

STRATEGY: *In view of the disappointing sales of Jaguar to date, we recommend cutting back exposure to Atari's convertible bonds.*

Update on California Microwave

Security: 5.25% convertible subordinated debentures
Maturity: Dec. 15, 2003
Recent price: $104.75
Yield to maturity: 4.58%
Conversion price: $28.4375 per share
Recent stock price: $25.4 per share

California Microwave's recent results continued to show consistent growth in all major business segments. Its revenue rose 64% in the first quarter of fiscal '95 (ended Sept. '94), mainly owing to incorporating a full quarter of Telecom-Transmission System acquired in October 1993. The growth in the second quarter (ended Dec. '94) showed a normalized growth rate of 25%. Its earnings per share for the second quarter grew 25% and, for the first six months of fiscal 95, increased 22%.

Revenue from wireless communications equipment (microwave radios) continued its robust growth. Wireless sales showed a normalized growth rate of 47% in the second quarter and constituted 41% of total sales in the first half, up from 32% during the same period last year.

Satellite communications sales increased by 16% and represented 42% of total sales in the first half of fiscal '95. AT&T has recently awarded California Microwave a $40 million contract to supply satellite equipment for its Saudi Arabia telephone line expansion project. This contract will enable California Microwave to maintain the growth rate of satellite revenue at 15% in fiscal '96. However, without similarly significant orders thereafter, the growth of satellite revenue should slow down to single digit.

The defense electronics (intelligence system) segment, although of declining importance, showed impressive sales growth of 46% in the first half, sharing 16% of total sales. The increase was mainly due to a $25.8 million contract awarded by the US Army for additional Airborne Reconnaissance Low systems. Despite a general decline in US defense spending, California Microwave seems to have a solid position in a niche market (upgrading existing aircraft's electronic intelligence systems). Therefore, revenue should be stable in this segment.

California Microwave also has been able to improve its profit margin. Gross margin and operating margin increased to 27.7% and 8%, respectively, for the second quarter. The improvement mainly came from the growing share of higher-margin wireless sales and the increased proportion of product instead of system sales for satellite equipment.

The company has grown its wireless communication business by acquisitions and is continuing this strategy. It announced in January '95 a preliminary agreement to acquire Microwave Networks Inc. (MNI), a privately-owned, Houston-based manufacturer of microwave radios for the cellular and personal communications (PCS) markets. California Microwave will issue 3.35 million shares to MNI, which values the latter at approximately $86 million at the current market price. According to the management of California Microwave, MNI derives 90% of its sales from international markets (e.g., Latin America, China, the Philippines, Singapore, and Eastern Europe), and its average gross margin is approximately 45%, which is in line with that of California Microwave's existing wireless business. MNI's projected revenue for fiscal '95 (ended June) is approximately $60 million, implying a price/sales ratio of 1.4X, which is in line with market. Subject to both companies' shareholder approval, the acquisition should enable California Microwave to break into a large number of developing markets immediately and achieve economies of scale by consolidating the two companies' marketing/administrative functions.

The stock of California Microwave is currently trading at 19.1X trailing 12-month earnings and 16.5X prospective fiscal 95 earnings, which are below those of comparable companies (Chart 14). Furthermore, its price-to-book and price-to-sales ratios are also substantially below those of its competitors. With expected average earnings per share growth in excess of 25% in the next few years, its stock should warrant a multiple of 22X to 23X fiscal '95 earnings (equivalent to 90% of 95 revenue), which means a target share price of $34 to $35 in six to 12 months. It represents an appreciation potential of 35% to 39%.

The convertible bond continues to be an excellent alternative to the stock because of its low 15.2% premium and short breakeven period of three years. If the stock goes up to $34, the convertibles should trade at $122 with a 2% premium, which represents an upside participation of 47%. If the stock reaches its target price in 12 months, the total return of the convertible bond will be approximately 18.5%. Downside participation is estimated at 40% to 45%. The convertible bond is not callable until January 1, 1997.

STRATEGY: *The stock and convertible bonds of California Microwave have appreciated by 38% and 16%, respectively, since our recommendation in April 1994 ($18.25 per share and $90.50 per bond). The upside participation of the convertibles has been approximately 42%. The company continued to show impressive revenue and bottom-line growth, and is on track to capitalize on the fast-growing wireless communications equipment market. Its current valuation is still low relative to other microwave companies whose share prices have skyrocketed during the same period. Consequently, the convertible bond is a strong hold.*

– Edison Lee, CFA

All prices in "Friedberg Capital Markets" are closing prices for March 24, 1995.

Chart 14 – Comparative Valuation of Microwave Companies

	Market Cap ($ million)	LTM* P/E	Prospective P/E	LTM Price to revenue	Price to book	Debt to market cap
California Microwave	$312	19.1X	16.5X	0.7X	2.0X	0.46
Scientific Atlanta	$1,821	30.6X	27.4X	1.9X	4.2X	0.14
Andrew Corp.	$2,462	34.1X	29.4X	4.2X	8.7X	0.06
Digital Microwave	$170	20.6X	16.4X	1.1X	4.4X	0.35
Motorola	$31,518	20.7X	17.3X	1.4X	4.1X	0.28

* LTM = Last 12 months

Chart 15 – Recommended current portfolio allocations

1. Mexican Cetes	5%	5. CIL NZ$	5%
2. Seabil Ltd NZ$	5%	6. FRB/BIC V	20%
3. New Zealand (8%) '98 Gov't	35%	7. U.K. FRN	15%
4. Tranz Rail NZ$	15%		

HOTLINE UPDATE

Tuesday, February 21, 1995:
Good afternoon for Tuesday, February 21, 1995. There are no changes or new recommendations. The market letter is in the mail. Have a great trading day.

Friday, February 24, 1995:
Good afternoon for Friday, February 24, 1995. There are no updates for the past week. The market letter is in the mail.

Monday, February 27, 1995:
Good Morning for Monday, February 27, 1995. This is a flash update at 9:10 am. Cover short March copper positions at the market, cancelling previous stops of 136 close only. Have a great trading day.

Tuesday, February 28, 1995:
Good afternoon for Tuesday, February 28, 1995. There are no new changes or recommendations. Have a great trading day.

Wednesday, March 1, 1995:
Good afternoon for Wednesday, March 1, 1995, 5:30 pm. This is a flash update. We have two new recommendations. Sell June Canadian dollars at the market; place stops at 7195, close only. Buy May coffee at the market; place stops at 171.00, close only. Have a great trading day.

Friday, March 3, 1995:
Good afternoon for Friday, March 3, 1995. We have no new recommendations. The following is a recap of this week's recommendations. On Wednesday, via flash update 5:30 pm, we advised to sell June Canadian dollars at the market, placing stops at .7195, close only; on Thursday June Canadian dollar opened at .7107. We also advised to buy May coffee at the market, placing stops at 171.00, close only. May coffee opened at 185.50. Have a great weekend.

Tuesday, March 7, 1995:
Good afternoon for Tuesday, March 7. We have one new recommendation. Sell June Eurodollars at 93.25 or better. Alternatively you may wish to buy June 93.00 strike Eurodollar puts at .15 or better. Have a great trading day.

Friday, March 10, 1995:
Good morning for Friday, March 10, 9:45 am. This is a flash update. Liquidate the long deutschemark/short yen cross position at the market; the cross is presently trading at .6445.

Friday, March 10, 1995:
Good afternoon for Friday, March 10. We have one new recommendation. Raise stops on short June Canadian dollar positions to.7135, close only.

The following is a recap of this week's recommendations. On Tuesday, we advised to sell June Eurodollars at 93.25 or better, or alternatively to buy June 93.00 strike Eurodollar puts at .15 or better. On Wednesday, June Eurodollars opened at 93.34, and the puts opened at .12. This morning at 9:45 am via flash update, we advised to liquidate long deutschemark/short yen cross positions, then trading at 64.45.

Monday, March 13, 1995:
Good morning for Monday, March 13. This is a flash update at 9:45 am. We have two new recommendations. Buy June gold at the market, presently trading at 391. Place stops at 380, close only. Buy May silver at the market, presently trading at 4.75; place stops at 4.37, close only. NOTE: We remain long April platinum with stops at 399, close only.

Tuesday, March 14, 1995:
Good afternoon for Tuesday, March 14. We have one new recommendation. Buy May copper at the market. Place stops at 129.00, close only. Have a great trading day.

Wednesday, March 15, 1995:
Good afternoon for Wednesday, March 15, 5:30 pm. This is a flash update. Lower stop on short June Canadian dollars to 71.00, good anytime. Have a great trading day.

Friday, March 17, 1995:
Good afternoon for Friday, March 17. We have two new recommendations. Buy July wheat at the market; place stops at 322, good anytime. Cover short June Canadian dollars at the market, cancelling the .7100 stop.

The following is a recap of this week's recommendations. On Monday, via flash update at 9:45 am, we advised to buy June gold, then trading at 391.00, placing stops at 380., close only and to buy May silver, then trading at 4.75, placing stops at 4.37, close only. We advised to remain long April platinum with stops at 399, close only. On Tuesday, we advised to buy May copper at the market, placing stops at 129, close only. On Wednesday, via flash update at 5:30 pm, we advised to lower stops on June Canadian dollars to 71.00, good anytime.

Tuesday, March 21, 1995:
Good afternoon for Tuesday, March 21. We have no new changes recommendations. Have a great trading day.

Friday, March 24, 1995:
Good afternoon for Friday, March 24, 1995. We have three new recommendations. Raise stops on May sugar to 13.75, close only; on May copper to 136.00, close only; and on May cocoa to 1290, close only.

This is a complete summary since our last market letter dated February 20, of all liquidations of open positions and new recommendations that remain outstanding. On Monday, February 27, via flash update, we advised to cover short March copper at the market, then trading at 134.40.

On Tuesday, March 7, we advised to sell June Eurodollars at 93.25; alternatively to buy June 93.00 strike Eurodollars puts at .15 or better. On Wednesday, June Eurodollars opened at 93.34, and the options opened at .12.

On Friday, March 10, via flash update, we advised you to liquidate the long deutschemark/short yen cross at the market, then trading at.6445.

On Monday, March 13th, via flash update, we advised to buy June gold at the market, then trading at 391 and to buy May silver at the market then trading at 4.75. Stops were placed at 380 and 4.37, close only.

On Tuesday, March 14, we advised to buy May copper at the market, placing stops at 12900, close only. On Wednesday, May copper opened at 135.65.

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