

# FRIEDBERG'S

## COMMODITY & CURRENCY COMMENTS

Friedberg Commodity Management Inc.



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### Pushing their luck

If your job depended on successfully reading tea leaves, chances are that you would be out of a job in a very short time. Not so the members of the Board of Governors of the Federal Reserve. Having used discretion flawlessly, and against all odds, a number of times in the past eight years, they pressed their luck and moved to preempt an imaginary recession.

Well, it looks like this time the tea leaf readers were wrong. Friday's data showed retail sales for June increasing 0.7%. Even more significant, April and May figures underwent large revisions: down 0.1% from the 0.3% decline originally reported and up 0.9% from an originally estimated and slim 0.2% rise, respectively. Clearly, retail-sales growth accelerated in the second quarter of the year, precisely the opposite impression that had been created from the previously available data.

Moreover, the much ballyhooed inventory overhead that gave so much concern to Alan Blinder & Co. proved to be nonexistent. Businesses increased their inventories only 0.4% in May, while sales rose 0.5% for the month, putting the inventory-to-sales ratio at 1.41 for the month, down from 1.42 in April. The point, of course, is not that we are better forecasters than the Fed (after seeing Monday morning's headlines). The point is that tea leaf readers and fine tuners will inevitably get it wrong. And when they do, *they* may not lose their jobs, but it will cost all of us dearly.

Rather than trying to guess the course of the economy, the Fed should have paid more attention to the explosion in credit aggregates that we documented last month and/or to the searing rate of growth of M2 (over the past 2 months this aggregate has grown at almost 9% per annum, the fastest rate of growth in many years). This explosion in credit and monetary aggregates, unless reversed very soon, is certain to lead to an explosion in aggregate spending and accelerating inflation. Which leads us back to last month's suggestion: The Fed's mission should be to fight inflation; it should not to try to spur the economy.

Milton Friedman, the doyen of monetarism and now a senior research fellow at the Hoover Institute, commented a few days ago that in his opinion, "the Fed should not engage in fine-tuning the economy and should use the only instrument it controls, namely the monetary base...the Fed effectively controls only one instrument, and that's high-power money,

or the monetary base...it would be so much better for the Fed and everybody else if they stuck to the base, announced each month or each year by how much they are going to increase the base and let the market determine interest rates."

Friedman reiterated his view that it is a mistake for the Fed to conduct monetary policy by targeting the federal funds rate, calling this method "very clumsy and inefficient."

Our view has been even more radical. Governments have no business running money. Government interference in monetary matters has brought us only grief. We need not go further than the real estate boom/bust cycle of the '80s in North America, UK, and the Scandinavian countries. Or the boom and (still) bust(ing) Japanese asset market of the past eight years. And now, courtesy of the Fed, the once-in-a-generation stock market frenzy that will end, just as surely as

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Contributions by Albert D. Friedberg, Dr. Steve H. Hanke, Edison Lee, Sholom Sanik, Eric Duhaime and Pierre Desrochers.

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

**NOTE: As usual, we will not publish in August. The next issue will appear in September.**

night follows day, with the destruction of hundreds and billions of dollars of savings.

The Fed's good fortune is running out. Commodity prices led by soaring grain prices are confirming the bottom in interest rates, challenging the Fed's recent easing move. We fully expect the 30-year Treasury bond to fall to new lows for

this cycle, making a mockery of the tea leaf readers and fine tuners at the Fed.

**STRATEGY:** Remain short T-bonds (position initiated on June 7), lowering stops to 116.06, close only, basis September '95.

Chart 1



## ARGENTINA

Great investment opportunities present themselves only when perceptions stray very far away from reality. Because markets are fairly efficient, these situations are very rare. You might then legitimately ask, "How then does such a gap ever occur?" The answer lies not so much in the market's inability to obtain the relevant information but in the market's process of assimilating this information, and more particularly in its ability to differentiate situations. In other words, markets are much weaker in making qualitative assessments than making quantitative assessments. Although this may sound like a truism, it is a fact often overlooked today, at a time when progress in communication and information has dwarfed the imaginable.

Quantitative factors are tangible; they can be touched, listed, counted, and run off on a computer. Qualitative factors

are intangible and very hard to define. As an example, of two companies in the same industry with almost identical resources, one will succeed and one will not. Of two countries in the same continent with almost identical resources, one's standard of living will improve, while the other's will not. The difference will probably lie in its people, its culture, and its management.

This brings us to Argentina, where a yawning gap between perception and reality has offered discriminating investors the opportunity to earn almost obscene returns. Painting Argentina with the same brush as Mexico, Brazil, and Venezuela is a major gaffe, because it ignores the facts behind the numbers. Over the years, we have not tired of emphasizing these qualitative differences. The following article by Dr. S. Hanke provides us yet with another illuminating insight.

# Argentina, the "Germany" of South America?

By Dr. Steve H. Hanke

After suffering the trauma of the 1922-23 hyperinflation, no people has taken the call for sound currency and credit systems more to heart than the Germans. As West Germany's first Chancellor, Konrad Adenauer, put it: "Safeguarding the currency forms the prime condition for maintaining a market economy and, ultimately, a free constitution for society and the state." Not surprisingly, Adenauer's economics minister,

Ludwig Erhard, went so far as to proclaim that monetary stability was a basic human right. These sentiments are shared by all political parties in Germany: Indeed, one of the pithiest pronouncements on the need for sound money was uttered in parliamentary debate by Karl Schiller, the Social Democratic economics minister from 1966 to 1972: "Stability is not everything, but without stability, everything is nothing."

The German views on sound money are enshrined in the Bundesbank Law of 1957. The law charges the central bank with one, and only one, objective: to defend the value of the mark. And that is just what the Bundesbank does. Indeed, in the post-Bretton Woods era, the mighty mark has been the world's most stable currency. This performance is, of course, music to the ears of most Germans: A recent poll found that almost 80% of the Germans identified their Germanness with the stability, strength, and international prestige of the mark.

I conjecture that Argentina is well on its way to becoming the "Germany" of South America. The so-called convertibility law, which took effect on April 1, 1991, provides the proper legal foundation for sound money. And the public's support of the Menem government's tough adherence to the law provides evidence to support my conjecture.

The convertibility law requires the peso to be freely convertible at a 1 to 1 rate with the US dollar. In addition, the peso's monetary base must be fully backed by US dollar reserves. The sceptics argue that these requirements amount to nothing more than irksome constraints on discretionary monetary policy, and that Argentina will eventually tire of these constraints, throwing its currency board setup into the proverbial dust bin.

I find this argument less than convincing, primarily because of Argentina's history and the lessons that have been learned from it. Argentina had a currency board in place from 1890 until 1935. During the 1890s, the currency board was dormant. It merely served as a conduit for the issue of fiat money. In 1902, the board began operating as a real currency board. The exchange rate of the "paper" peso was fixed to gold. While the fiat issue of pesos that the board inherited was virtually unbacked by gold, new pesos could be issued only if they were backed 100% by gold reserves. The demand for new pesos grew rapidly. Consequently, gold cover for all outstanding pesos rose from only 0.11% in 1902 to almost 73% in 1913. With the outbreak of World War I, Argentina arbitrarily suspended the export of gold and operations of the currency board.

During World War I, the peso remained near its prewar parities against the US dollar and sterling. The worldwide recession of 1920-21 depressed the value of Argentine agricultural exports, causing the floating peso to fall nearly 50% against the US dollar. In the mid 1920s, economic conditions improved, and the peso appreciated steadily. Argentina permitted the export of gold again in 1925 and resumed the gold standard currency board on August 25, 1927.

Argentina's return to gold convertibility and the currency board system was brief, however. Rising interest rates in the United States drew capital out of Argentina. From July 1928 to the end of 1929 Argentina suffered a gold outflow roughly equal to 40% of the combined reserves of the currency board and the commercial banks. On December 16, 1929, the currency board and peso convertibility into gold were once again arbitrarily suspended. In 1935, Argentina established a central bank. Thus, the currency board operated as a real board for only 14 years, from 1902 to 1914 and 1927 to 1929.

The high reserves that the board held on the eve of both suspensions of convertibility indicate that the suspensions were not the result of problems with the currency board system *per se*. Rather, the suspension indicates that Argentina was a "fair weather" adherent to the gold standard. So long as the gold standard promised stable prices and a continuing economic boom, the government favored it. As soon as the gold standard required a temporary deflation and readjustment of the economy, the government abandoned it.

Incidentally, this experience was not unique to Argentina. Writing in 1932 about the history of the gold standard, the great Austrian economist, F.A. Hayek, concluded that, "Every effort has been made to obviate its functioning at any point at which there was dissatisfaction with the tendencies which were being revealed by it."

As Argentina's history illustrates, a government can ultimately revoke a currency board's franchise. This government interference has not served Argentina well. Argentina suffered from the recession in the early 1920s and the Great Depression along with everyone else. Furthermore, since World War II, Argentina has experienced repeated bouts of hyperinflation.

Like the Germans, I believe the Argentine people have learned the lessons of history. As irksome as a currency board's constraints might appear, the people have concluded that Argentina's strict monetary constitution is the best, if not the only way, to maintain a sound currency.

This isn't the end of the story, however. Some of those who argue that Argentina will not arbitrarily abandon its currency board, claim that the peso is overvalued and must be devalued. This claim is not valid. It is true that inflation, measured on a consumer price index basis, has been higher in Argentina than in the US. Consequently, when measured on a CPI basis, the real value of the peso has been appreciating against the dollar.

What matters, however, is not the domestic inflation in Argentina, but inflation in traded goods. On the basis of wholesale prices, which reflect inflation in traded goods, Argentina's have remained on par with those in the US since 1991, when the currency board was installed. As long as productivity in Argentina exceeds that in the US, these consumer and wholesale price indexes between Argentina and the US will remain the same, and Argentina's peso will remain competitive.

The peso overvaluation argument is just wrong, both in theory and practice. Indeed, if the peso is so overvalued, why have Argentina's exports exploded? Over the first 6 months of 1995, exports are up over 45% from the same period in 1994.

Argentina's currency board is here to stay, and so is the peso-dollar exchange rate.

*Dr. Hanke is Chief Economist for Friedberg Mercantile Group and adviser to Argentinean Finance Minister Domingo Cavallo.*

**STRATEGY:** *The Republic of Argentina Bocon pre 1 (in pesos) and pre 2 (in dollars), yielding in excess of 26% and 22% to maturity, respectively, continue to represent one of the most outstanding investment opportunities anywhere in the world.*

**FOR THE RECORD**

## At least *somebody* is thinking right

Back in February, we penned a piece entitled "Mexico: wrong prescription, wrong signal." We are happy to report that just four days later, Gerd Haeusler, Bundesbank council member concurred in a most forceful manner. Following, we reproduce parts of a Reuters News story dated February 24, which came to us courtesy of a good client.

"Mr. Gerd Haeusler called the aid package arranged for Mexico a "bailout" for investors who should have been forced to take losses. He said that banks and other financial firms must even be allowed to fail as a way of enforcing discipline and avoiding the expectation that monetary authorities will always intervene.

"The moral hazard is today's and tomorrow's challenge," Haeusler said. 'In Mexico it was in my mind not only a bailout of Mexico but also a bailout of banks and institutions that engaged in risky investments.'

"These investors 'wanted Mexican rates and U.S. depository insurance. I think this should not happen.'

"It is essential that investors face the possibility of losses on risky investments,' Haeusler said, adding, 'a bailout of that magnitude will distort price mechanisms' and invite the need for further bailouts.

"Haeusler said in his experience as a bank supervisor, he has been 'absolutely categorical that banks had to make losses and make writeoffs...so banks would learn a lesson' about risky investments.

"The most important rule of today is to make sure that banks and financial institutions make losses. Losses are extremely important.... Financial institutions must be allowed to fail. I say this very deliberately' in the context of the 'financial crisis of today, which is Mexico.'"

Well said!

**CURRENCIES**

## On the yen's troubles

The US dollar's weakness has been palpably demonstrated: An official Treasury/Bank of Japan agreement to drive the dollar up to ¥90 has fallen flat on its face, despite repeated interventions and threats that speculators would lose money if they resisted the effort. Haven't they already learned that the best that they can do is to remove the most speculative factor in the market, i.e., the one that buys on strength, sells on weakness and gets on the bandwagon? In short, the destabilizing element. Shame on them. For now, they have shown their impotence and will be reduced to waging a rear-guard action.

Desperately trapped in a deflation, the Bank of Japan has once again lowered rates, this time to 0.75%. While its foot is down on the monetary accelerator, it has not as yet floored it. But by all rights, it would be entitled to do so. While the finance ministry admits to \$470 billion of bad loans, private estimates now put the true problem at \$825 billion. A staggering sum, equal to almost 20% of the money supply. The continuous decline in asset prices will make even this number appear small in six months' time.

Japan has little choice but to reflate on a massive scale. This means new tax cuts equal to 5% to 8% of GDP, and accelerating the growth of broad money from the current

3.2% per annum to 6%-8% per annum. At the same time, Japan must further deregulate the economy, taking significant steps to break up its cartelized distribution system, which has been responsible for keeping retail prices from reflecting the falling import and wholesale prices.

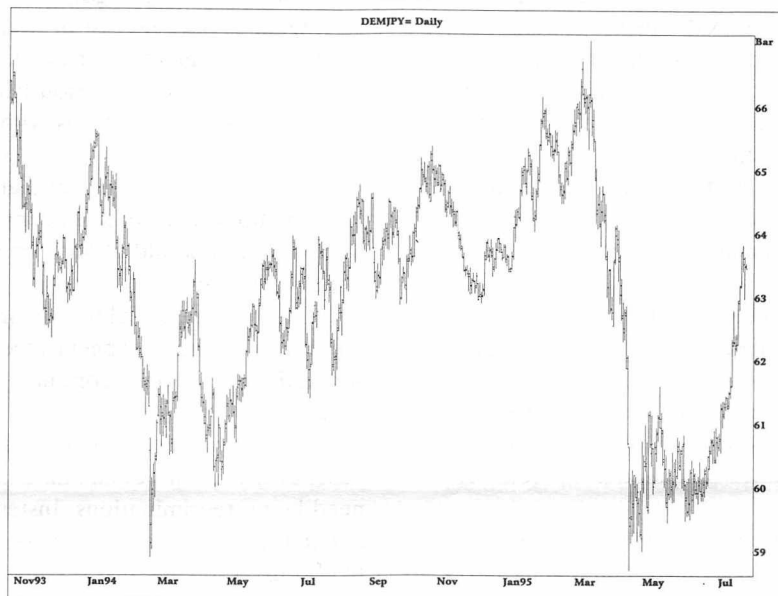
Furthermore, Japan will have to move to force the banking system to bite the bullet on its bad loans, and repossess and liquidate collateral where possible.

Tax cuts and the accelerated fall in real estate and consumer prices would increase purchasing power and move Japan out of its stagnation/depression. At the same time, increased domestic activity would narrow the trade balance and stop the repatriation of funds from abroad (now being used to prop up the tottering balance sheets). Both of these events will coincide to significantly weaken the yen.

Sooner or later the yen will depreciate. However, given the weakness of the US dollar, it would be preferable to trade the Japanese yen from the short side against the European currencies, and in particular the deutschemark.

**STRATEGY:** *You are long DM and short yen as per flash update of July 18. Place initial stops on this cross trade at 60.85, New York close.*

Chart 2



**CANADIAN DOLLAR**

**Climbing a wall of worry**

With the Quebec referendum in sight, dire warnings are beginning to circulate on the implications of separation. A recent C.D. Howe Institute paper concludes that the Province of Quebec would risk bond default and face the prospect of a longer-term solvency crisis. These events could easily trigger a liquidity crisis for Canada, involving a massive selloff of the dollar and government bonds. Canada year after year.

We respectively disagree and reprint alongside a much kinder interpretation of the implications for Quebec's separation.

Besides, the markets don't seem to care. The Canuck buck trades up, climbing a wall of worry.

**STRATEGY:** *Remain long, risking 72.65, basis September '95, close only.*

**QUEBEC**

**Split and prosper**

*by Eric Duhaime and Pierre Desrocher*

When discussing the secession of Québec from the rest of Canada, many Anglo-Canadian economists become doomsday preachers of apocalyptic scenarios. They predict social calamities such as poverty, mass unemployment, civil war, and mass exodus.

They should settle down, try to be rational, and focus on the only real issue, the long-term economic well being of Québécois and Canadians.

Some people estimate that if Québec secedes, it would bear a transition cost of 2% of its GNP. It's possible. But this price must be balanced against the huge tribute Québec currently pays to stay in the union — among which is the cost of political uncertainty. It would be better to pay the costs of separation one time, rather than pay for an unworkable

Canada year after year.

The Fraser Institute tells us that "an independent Québec would rival the Third World in terms of its all-government indebtedness." But as the same group pointed out elsewhere, Canada already ranks behind Burundi and just ahead of Morocco in indebtedness. There's nothing new in debt. What's new is the chance to get out of it. This is what separation offers.

It is demagoguery to compile the costs of sovereignty without addressing the costs of a unified Canada. People forget the \$3 billion lost annually to Ottawa-Québec feuding over jurisdiction and program duplication. Québec is a small and socially cohesive entity. It is capable of reaching political consensus on key questions rather quickly. These gains from separation would be huge.

A cliché holds that “this country was built by government.” Indeed, but again at what cost? The union has forced on Québec a long line of government interventions, including protectionism, a huge welfare state, pricey railways and canals, largess such as Air Canada, and fantastic expenses in bilingualism and multiculturalism.

Under separation, all these costs would at least be negotiable. Today, Québec has no choice but to pay them. Indeed, keeping the union together is a major purpose of these interventions in the free market.

More than ever, Canada is kept together by government programs. The government’s make-work spending, redistribution policies, and debt accumulation (which mortgages the future) concentrates benefits in the hands of privileged minorities. The costs are spread onto all taxpayers. Can any serious economist argue that this dilapidation reflects economic efficiency?

Attempts to appease political tensions have cost billions of dollars. After being caught in an unworkable federation for 127 years, it is time to ask whether this battle is any longer affordable.

Québécois and Canadians have an option. They can continue along this aimless and unprofitable path. Or they can give themselves two or more independent countries that would conform more closely to economic common sense.

Without a central government bankrupting everybody else, Québec and the rest of Canada would have no choice but to trade, compete for capital, and be productive on their own terms. This competition between countries will drive down regulations and taxes within countries, and thus increase prosperity for all.

As for those who believe that the road to prosperity lies in protectionism instead of openness, welfare instead of productivity, they would at least be accountable for their own impoverishment.

Given the peaceful history of the Canadian experiment, there is no reason to expect fierce battles or act of spite after separation. It is only continuing union which raises that specter.

Let’s put political feuds behind us and recognize the obvious truth. The Canadian experiment has failed. There need be no recriminations. Instead, let’s solve, in a durable manner, the constitutional mess, face the real challenges of the future, and get our economic houses in order. Let’s split and prosper.

*Eric Duhaime and Pierre Desrochers are Quebec graduate students and authors of the winning paper in the Mises Institute’s competition for “Secession, State, and Economy.”*

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**STOCK INDEXES**

**Feeling toppy?**

Don’t bet on it just yet, but this may be *it*. There is nothing more difficult for a trader to do than to pick a top. Particularly, the top of the longest and most powerful bull market in history.

There is no need to rehash the litany of bearish fundamental and technical factors. They are all well known. What is important is to judge when the tide has turned. The technology stocks have been the generals of this bull market. The possibility that they have been mortally wounded in this week’s carnage may sound the retreat for the overall market.

The timing is ideal — just following the release of second-quarter results, confirming a distinct drop in corporate profit margins. The levels attained this past Monday — 566 on the S&P 500 Composite Index and 4767 on the Dow Jones Industrial Average — are within a hair’s breadth of our forecast of 570 and 4900, respectively, made in our comments of May 21.

**STRATEGY:** *Here is what we will monitor for confirmations of a top: between two and five days of narrowing day ranges, inside of Wednesday’s (July 19) range, accompanied by shrinking volume. Once this condition is given, we will move with the breakout. If you find these instructions too vague or*

*too hard to understand, stand by. We will decipher them for you and give you a crisp message over our Hotline, though with no guarantees of profitability.*

Chart 3



**SOFT COMMODITIES****Cocoa**

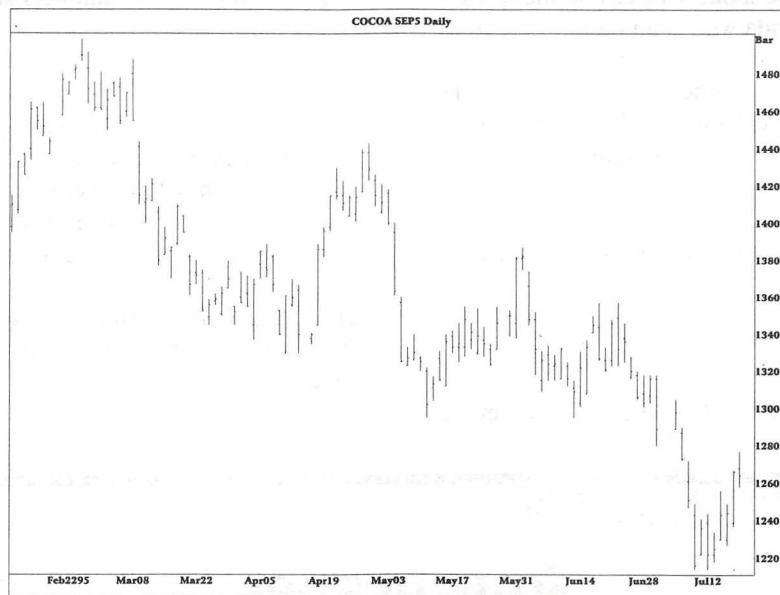
Cocoa is getting a bad rap. On July 10 it was reported that the German cocoa grind, one of the important demand indications, was down 17% for the second quarter *vis à vis* the same period last year. A few days later cocoa traders Albrecht and Dill explained the questionably large drop. There had been a shift in manufacturing schedules, which will make the grindings show up in a different quarter. Some processing has moved to the Netherlands, and the Dutch numbers were higher.

In previous issues we discussed the deficit that exists in this market, and owing to the uniqueness of cocoa's growing

cycle, this is not something that will go away. So, while demand does remain seasonally weak, the commercial sector is having a pretty good time accumulating a long position in a market participants feel is very cheap. This allows commodity funds to believe the market has much downside potential. The most recent slide has been accompanied by a commitment of traders report that confirms this pattern. The bear trap is being set.

**STRATEGY:** *Our patience has paid off. Prices have eased a further \$100/tonne since last month. Buy September '95 cocoa at the market, and place initial stops at 1210, close only.*

Chart 4 – Cocoa

**Corn**

Last year, fearing burdensome stockpiles generated by years of bountiful crops (culminating in 1994's 10.103 billion bushel harvest), the USDA ordered corn farmers enrolled in its price-support program to idle 7.5% of their eligible land. Hardly burdensome, the July USDA figures for US production show a downward revision to 7.785 billion bushels from 7.9 billion bushels, bringing ending stocks down to 725 million bushels from 748 million bushels from last month's estimate.

These grim statistics paint a bull market picture even under optimum weather conditions. However, as the corn plants enter their crucial pollination stage, it must not be forgotten that the crop was planted late because of the very wet spring in the US Midwest. This actually pushes the pollination period ahead to the hottest part of the summer, which in addition to the already tight conditions creates the potential for an explosive weather market as well.

China has been releasing corn from its strategic stock-

piles to alleviate tight domestic conditions and has been an active importer. (China used to be an exporter.) So as the supply outlook worsens, the demand side remains robust. The price has been grinding on towards \$3.00, having suffered a setback to below \$2.70, which served to lighten a temporarily overbought condition.

**STRATEGY:** *It is a demand-driven bull market. Any supply problems will only add more fuel to the coming explosion. Buy September '95 corn at the market. Place initial stops at 276, good anytime.*

**Sugar**

Sugar prices are nothing to cheer about. Every statistician on both sides of the ocean agrees that the 1994-95 season has broken the string of production/consumption deficits and will enjoy a healthy surplus. F.O. Licht's estimate brings the vital stocks-to-consumption ratio to 33.3% of consumption

from its February estimate of 31.4%, a move comfortably away from the widely watched danger level of 30%. Just about every major producer scored unexpectedly fantastic crops. Only a few months ago we speculated on how much India would import, but as its crop was revised upwards so many times until it reached 16 million tonnes, it is now expected to become a net exporter.

The scenario for next year should not be much different, as Licht's estimate for global production of 120 million tonnes for the 1995-96 campaign would be the largest crop on record. Consumption, they say, will grow, but will be outpaced by a crop of such size.

Brazil eliminated its threatened export tax, which relaxed any anxiety about short-term supply problems.

All in all, the supply side picture has "bear" written all over it.

Looking to the future, we spoke to an Economics Professor at the University of Florida who is an author of a study done to measure the potential effects of the elimination of subsidies in the United States and the European Union. The study confirmed what we've been saying. Much higher prices would eventually result, as production would become unprofitable for farmers.

**STRATEGY:** *Stopped out at our recommended 1030 stop. Stand aside.*

## Wheat

To illustrate the potency of the budding bull markets in

grains, consider this: Carryover stocks of all grains worldwide heading into 1996, measured in days of supply, is estimated to be 53 days, down from 62 days going into 1995. The only year that came close to having such a meager supply was 1973 at 56 days. Then, the markets all but doubled in price. The world is hungry, and the cupboard is going bare.

Let's examine 1995's darling of the grain pits in Chicago, wheat. The weather got off to a bad start this spring with excessive wetness dealing a double blow. The two overlapping crops were each affected by the same weather pattern. The winter wheat, planted in the autumn, and harvested in the spring couldn't be collected from the fields properly, because of the continual downpours. The wheat suffered rot, and thus yields were reduced. The same rains did not allow the spring wheat to be planted on time, with many farmers abandoning wheat acreage in favor of other crops that can be planted later.

The July USDA numbers show what's happened. Production for 1995-96 is estimated at 2.188 billion bushels, down from the June estimate of 2.26 billion bushels, and down from the 1994-95 production of 2.321 billion bushels. The vital carryover stocks will dip down to a mere 428 million bushels. These stocks have been dwindling for years. The effect of such a low level of emergency supplies will ultimately be felt when a disastrous crop like the one we're having now could cause a genuine shortage.

**STRATEGY:** *You are long September '95 wheat at around 4.50 as per the flash update of June 29. Raise stops to 4.20, close only.*

— Sholom Sanik

## FRIEDBERG CAPITAL MARKETS

### Sour grapes?

We don't know what Mr. Fraser, governor of the Reserve Bank of Australia had for breakfast on July 11. But he sure had a big chip on his shoulder. At a luncheon of journalists, he said that the Reserve Bank of New Zealand could afford to operate a *laissez faire* banking supervision system, because Australia in effect supervised most New Zealand banks and that in a way "they are getting it on the cheap."

He also said that Australia's and New Zealand's current account records cannot usefully be compared with each other because of the differences in the two countries' export basis, adding that "they are little lucky really that they export a lot of pulp and paper and their reproductions, the prices of which have been pretty good for some years."

Come on, Mr. Fraser! What about everything else, like their fiscal surplus, their Fiscal Responsibility Act, which sets out general principles for prudent fiscal policy, publication of government accounts similar to those of private sector firms (independently audited), their independent central bank, their highly deregulated labor market etc. etc.?

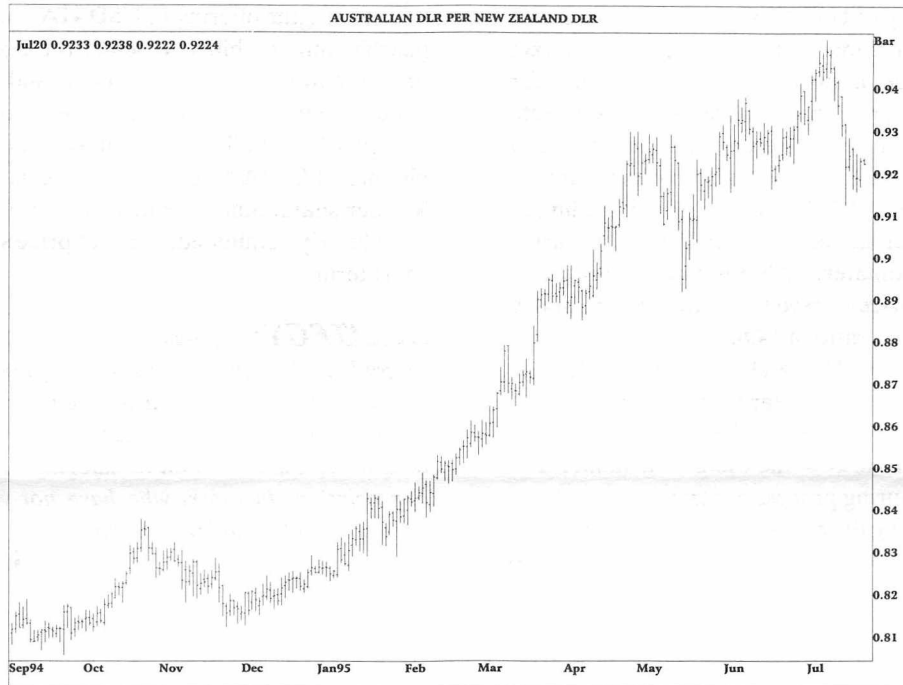
Is Mr. Fraser frustrated because the Kiwi dollar has just made a new all-time high against the Aussie dollar (see Chart 5)? Or is it that Australian government debt trades 250 basis points through NZ treasuries?

New Zealand is a success story because they worked hard at it. Luck shines on those who rise early.

**STRATEGY:** *Tight money is starting to produce results. The underlying inflation rate is only barely above the 2% self-imposed ceiling. As a result, the Reserve Bank is unlikely to insist on further Trade-Weighted Index appreciation and may rest content with the recently attained 62 level. This reduces somewhat the upside currency potential, which has done so much to improve the total return obtained on the NZ\$ bonds.*

*We are therefore modestly reducing our allocation in NZ\$ bonds to 50% from 60%. At the same time, we advise increasing exposure to New Zealand equities and in particular proprietary issues, such as the Kiwi Income Property Trust.*

Chart 5



**FRIEDBERG CAPITAL MARKETS**

## Update on Safeguard Scientifics, Inc.

**Security:** Common stock (NYSE: SFE)  
**Recent price:** \$41 per share  
**Market cap:** \$402 million  
**52-week range:** \$12.5 - \$46.75

Since our first recommendation on Safeguard Scientifics in May, its share price has gone up by approximately 43%. We believe at this price level, the stock will have a short-term consolidation. The next major move will depend on the share price performance of USDATA, a subsidiary that Safeguard is taking public, after the stock starts trading, and whether some other subsidiaries are ripe for a public offering.

The recent run-up in Safeguard's stock price is due to the significant share price appreciation of Coherent Communications, a 40%-owned subsidiary of Safeguard, and the rights offering of USDATA. Coherent Communications' shares have risen by 33% in the past month following a 2-to-1 stock split. It made a very bullish analyst presentation in New York, indicating significant revenue and earnings growth potential.

The rights offering of USDATA is what pushed the stock up to \$46 on June 19, the last date before the stock started trading ex-rights. The stock price came down afterward mainly to reflect the value of the rights.

In the rights offering, Safeguard is offering holders of its common share one right for every four shares held. Each right enables the holder to purchase one common share of USDATA at \$5 per share. It was estimated that a total of

2,550,000 rights would be issued. The right is currently trading at approximately \$15, which is equivalent to \$3.75 per Safeguard share. The rights will expire worthless at 5:00 pm on July 21, 1995.

USDATA provides a wide range of software, hardware systems and design consulting/support services used by its clients to improve productivity and monitor their automation process. Its family of software products, marketed under the name of FactoryLink, enable a company's information system to supervise, monitor and control manufacturing and other automation processes and to interact with the organization's management information system. For the three months ended March 31, 1995, FactoryLink contributed approximately 58% of USDATA's total revenue, and its share has been rising over the past four years.

In addition, USDATA is also engaged in the design and implementation of third-party data collection systems that allow remote, real-time data collection using various automatic identification techniques (e.g., bar coding). It employs various proprietary software to add value to the hardware components of such systems.

USDATA's core strengths are its multi-platform software development capabilities in manufacturing/automation process control and its long list of blue chip customers. The company uses a worldwide direct sales force to market its products to target industries. Some typical industries that place heavy emphasis on process control include chemical,

oil and gas, beverage, and pharmaceutical.

The current strategy of USDATA is to expand its direct sales force in international markets and aggressively market its products to these target industries. The global market for real-time industrial automation software products is estimated at \$1.1 billion. With annual revenue of approximately \$40 million, USDATA has a lot of room to grow its top line.

The common stock of USDATA is currently trading at \$20 per share on a when-issued basis. It implies a market capitalization of approximately \$220 million, a 1994 price-earnings ratio of 70, price-to-revenue ratio of 5.5, and a price-to-net tangible assets ratio of 14.8.

Although we believe USDATA should have no difficulties growing its earnings by 25% a year for the next few years, the current valuation seems to be high. The upside lies in the potential for FactoryLink to become the global standard in computerized manufacturing process control.

We recommend selling the rights now. They have recently traded at approximately \$15. Play USDATA through Safe-

guard's remaining 28.3% holdings.

The rights offering of USDATA once again proved Safeguard's unique ability to select the right information-technology companies for investment and generate substantial capital appreciation. The latest net tangible asset value of Safeguard, excluding its privately-owned subsidiaries but including USDATA at its trading price, is approximately \$42 to \$45 per share. Since the discount to net tangible assets has been largely eliminated, its share price should stabilize in the short term.

**STRATEGY:** *Safeguard Scientifics continued to prove its foresight and acumen as a venture capitalist in the information-technology industry. Its investment in USDATA is another example. Investors in Safeguard should dispose of their rights to USDATA and hold on to Safeguard's shares for long-term appreciation. Investors who have not yet bought Safeguard should consider buying on a dip.*

— Edison Lee, CFA

**Chart 6 – Breakeven exchange rates for US\$-based investor**

This analysis shows a "snapshot" of the relationship between interest rate differentials and rates of exchange. The breakeven rate measures how far the foreign currency has to devalue (for NZ\$, A\$, DM, DKr, BP, FFr, CD, SAR, ECU, ITL, and ARG) or revalue for SF, JY, before the interest rate advantage/disadvantage is overcome by currency depreciation/appreciation. Rates as of July 19, 1995.

	US. \$	NEW ZEALAND	DEUTSCHEMARK	SWISS FRANC	JAPANESE YEN	DANISH KRONE	BRITISH POUND	FRENCH FRANC	EUROPEAN CURRENCY UNIT	CANADIAN DOLLAR	SOUTH AFRICAN RAND**	ITALIAN LIRA	ARGENTINEAN PESO	FINNISH MARKKA
1 year	5.60%		VEB 7% '96 yields 10.70% (DM/US 1.4404)								ESCOM '96 yields 14.03% (SAR/US 0.2548)	NIB '96 yields 11.63% (ITL/US 1.7040)		
2 year	5.85%				World Bk. '96 yields 0.65% (JY/US 78.9785)	Denmark '96 yields 7.50% (DKr/US 5.5191)	Sweden '96 yields 7.15% (US/BP 1.5609)	Cr. Lyon '96 yields 6.31% (FFr/US 4.8393)			R.B.C. '97 yields 6.83% (CDN/US 1.3901)			
3 year	5.95%													
4 year	6.04%		Argentina '98 yields 7.93% (DM/US 1.4746)	G.E. '98 yields 3.92% (SF/US 1.0580)										
5 year	6.14%	Tranz Rail '99 yields 9.01% (US/NZ 0.5916)												
6 year	6.20%												BIC V '01 yields 21.32% (ARG/US 2.2225)	
8 year	6.41%													
9 year	6.44%													
Spot Exchange Rate	—	0.676	1.374	1.147	87.35	5.351	1.5995	4.7795	1.346	1.3647	0.2751	1.612	1.00	4.2203

\*For example, since a US\$-based investor would receive 287 basis points (901-614) by holding the Tranz Rail NZ\$ bond, the NZ/US can depreciate to .5916 from the present spot exchange rate of .6760 over

the next 5 years for the NZ investment to break even with current US\$ rates of interest. Assumes that bonds are held to maturity, and coupons are reinvested.

**Chart 7 – FOREIGN CURRENCY BONDS**

DATE: July 19, 1995 We offer the following Bonds subject to change without prior notice: Minimum US \$5000 (CDN \$7000)

ISSUER / COUPON / MATURITY DATE	BID	OFFER	YTM	CURR. COUPON	NEXT INTEREST PAYMENT DATE
<b>DEUTSCHE MARK DENOMINATED BONDS</b>					
Bank of Nova Scotia 5 5/8% 7/5/96 RRSP eligible	99.80	-	-		May-07
World Bank 5 7/8% 4/02/97 RRSP eligible	103.30	104.15	3.04		Feb-04
World Bank 7 1/4% 13/10/99 RRSP eligible	104.30	105.15	5.83		Oct-13
World Bank 9% 13/11/00 RRSP eligible	115.75	116.60	5.32		Nov-13
Kingdom of Denmark 6 1/8% 15/04/98	101.05	-	-		Apr-15
Argentina 8% 5/10/98	99.30	-	-		Oct-05
Bk. Foreign Eco. Affairs 7% 29/3/96	96.65	97.50	10.70		Mar-29
Kgdm. of Spain (6 Mo. LIBOR-1/16) 29/6/02 (semi)	99.22	99.52	-	4.5625	Dec-29
<b>ITALIAN LIRA DENOMINATED BONDS</b>					
Nordic Inves. BK 12 3/8% 19/04/96	99.40	100.25	11.63		Apr-19
<b>SWISS FRANC DENOMINATED BONDS</b>					
General Electric 4 3/4% 2/7/98	101.40	-	-		Jul-02
<b>DANISH KRONE DENOMINATED BONDS</b>					
Kgdm. of Denmark 9% 15/11/96	102.15	103.00	6.49		Nov-15
<b>ECU DENOMINATED BONDS</b>					
United Kingdom 9 1/8% 21/02/01	106.25	107.10	7.50		Feb-21
<b>BRITISH POUND DENOMINATED BONDS</b>					
Kgdm. of Sweden 8 3/4% 29/5/96	100.35	-	-		May-29
<b>FRENCH FRANC DENOMINATED BONDS</b>					
Credit Lyonnaise 9 1/2% 23/12/96	103.00	103.85	6.51		Dec-23
<b>JAPANESE YEN DENOMINATED BONDS</b>					
World Bank 5 3/4% 7/8/96 RRSP	104.40	-	-		Aug-07
<b>CANADIAN DOLLAR DENOMINATED BONDS</b>					
Ontario Hydro 10 7/8% 8/01/96 (semi) RRSP eligible	100.70	101.95	6.45		Jan-08
Eksporfinans 7 3/4% 5/11/97	99.70	-	-		Nov-05
Royal Bank of Canada 9 1/8% 7/1/97 RRSP eligible	101.75	-	-		Jan-07
<b>SOUTH AFRICAN RAND DENOMINATED BONDS</b>					
ESCOM 12% 1/5/96 (semi)	97.65	98.50	14.03		Nov-01
<b>AUSTRALIAN DOLLAR DENOMINATED BONDS</b>					
Commonwealth Bk. of Australia 9 3/4% 15/5/96	101.10	101.95	7.07		May-15
<b>NEW ZEALAND DOLLAR DENOMINATED BONDS</b>					
World Bank 12.5% 25/7/97 (semi) RRSP eligible	108.90	109.75	7.21		Jul-25
New Zealand Gov't 10% 15/7/97 (semi)	103.35	-	-		Jul-15
New Zealand Gov't 8% 15/7/98 (semi)	100.90	101.75	7.34		Jul-15
Fletcher Challenge 10.75% 15/12/97 (semi)	103.05	103.90	8.90		Dec-15
Fletcher Challenge 10.15% 30/11/98 (semi)	102.55	-	-		Nov-30
Tranz Rail Ltd. 10% 15/10/99 (semi)	102.55	103.40	9.01		Oct-15
DB Group 7% 30/6/96 (semi) matures @ 85	89.05	89.90	4.56		Dec-30
Seabil Ltd. 9% 27/6/99 (semi)	90.15	91.00	12.28		Dec-27
<b>ARGENTINEAN PESO DENOMINATED BONDS</b>					
BIC V Fixed/Floating 1/5/2001 Callable	59.35	61.35	21.32	59.2	4 <sup>th</sup> day of mth.
Bocon Pre 1: 1/4/2001	64.75	66.75	25.75	130.25	May-01-97
<b>MEXICAN PESO DENOMINATED BONDS</b>					
Government of Mexico "CETES" 22/7/95	available on request				every 4 weeks
<b>U.S. DOLLAR DENOMINATED FIXED CONV. BONDS</b>					
Burnup & Sims 12% 15/11/00 CV@16.79 p/sh (semi)	97.25	98.75	12.32		Nov-15
Atari Corp. 5 1/4% 29/4/02 CV@16.31 p/sh	46.25	47.75	19.96		Apr-29
Coeur D'Alene 6% 10/6/02 CV@ 26.00 p/sh	89	90.5	7.83		Jun-10
Glycomed 7 1/2% 1/1/03 CV@14.06 (semi)	66	67.5	14.86		Jan-01
California Microwave 5 1/4% 15/12/03 CV@28.44 p/sh (semi)	104.25	105.75	4.42		Dec-15
<b>U.S. DOLLAR DENOMINATED FIXED RATE BONDS</b>					
World Bank 7 1/8% 27/9/99 (semi) RRSP eligible	103.85	104.70	5.84		Sep-27
Farm Credit Corp 7 3/4% 10/06/96 RRSP eligible	100.80	101.65	5.72		Jun-10
T.W.A. 10% 3/11/98 (semi)	73.00	74.25	19.99		N/A
<b>U.S. DOLLAR DENOMINATED FLOATING RATE NOTES</b>					
Kgdm. of Denmark 25/3/97 (Gold call, JY put), (semi)	72.40	73.40	-	8.45	Sep-25
United Kgdm. 30/9/96 3 mo. LIBID-1/8 (qly), callable @ 100	99.90	100.20	-	5.75	Sep-30
Bocon 1/4/01 (30 day LIBOR) starts paying May 1, 1997	75.00	75.85	21.05		May-01-97
Argentina: Series L:FRB 31/3/05, 6 mo. LIBOR+13/16 (semi)	59.75	61.25	17.48	7.3125	Sep-29
<b>GOLD</b> (in ounces, at market prices, can also be held in your bond account) <span style="float: right;">client eligibility determined at point of sale.</span>					

**Chart 8 – Recommended current portfolio allocations**

1. New Zealand (8%) '98 Gov't	20%	4. Tranz Rail NZ\$	10%
2. Fletcher NZ\$	10%	5. World Bk 7 1/4% '99 DM	30%
3. Seabil NZ\$	10%	6. Pre-1/Bocon	20%

**HOTLINE UPDATE**

**Tuesday, June 27, 1995:**

Good afternoon for Tuesday, June 27. There are no changes or new recommendations. Have a great trading day.

**Thursday, June 29, 1995:**

Good morning for Thursday, June 29, 10:30 am. This is a flash update. Buy September wheat at the market, presently trading at 450, placing stops at 411, good anytime. Have a great trading day.

**Friday, June 30, 1995:**

Good afternoon for Friday, June 30. There are no changes or recommendations. The following is a recap of this week's recommendations:

On Thursday, June 29, we advised to buy September wheat at the market, then trading at 450, placing stops at 411, good anytime. The market letter is in the mail. Have a great trading day.

**Tuesday, July 4, 1995:**

Good afternoon for Tuesday, July 4. There are no changes or new recommendations. Have a great trading day.

**Friday, July 7, 1995:**

Good afternoon for Friday, July 7. There are no changes or new recommendations. Have a great trading day.

**Tuesday, July 11, 1995:**

Good afternoon for Tuesday, July 11. There are no changes or new recommendations. Have a great trading day.

**Friday, July 14, 1995:**

Good afternoon for Friday, July 14. There are no changes or new recommendations. Have a great trading day.

**Tuesday, July 18, 1995:**

Good afternoon for Tuesday, July 18, 1:00 pm. This is a flash update. We advise liquidating the outright September deutschemark long position, at the market, currently trading at 7227, and in its place, we advise putting a long deutschemark/short Japanese yen spread, dollar weighed (approximately 3 deutschemark long to 2 Japanese yen short). Currently, the September cross is trading at 6330. Have a great trading day.

**Thursday, July 20, 1995:**

Good afternoon for Thursday July 20. This is a complete summary since our last market letter dated June 23 of all liquidations of open positions and new recommendations that remain outstanding.

On Thursday, June 29, via flash update, we advised to buy September wheat at the market, then trading at 450, placing stops at 411, good anytime.

On Tuesday, July 18, via flash update, we advised to liquidate the outright long September deutschemark, then trading at 7227. We made one new recommendation to put on a long deutschemark/short yen spread, dollar weighed (approximately 3 long deutschemark to 2 short yen). The September cross was then trading at 6330.

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