

FRIEDBERG'S

COMMODITY & CURRENCY COMMENTS

Friedberg Commodity Management Inc.



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We are long S&P (can you believe it?) but not for much longer, though

The six-week stock market consolidation that ended around Labor Day resolved itself on the upside, accompanied by good volume and breadth.

You will recall that following the July 19 "technology" break, we hypothesized a bull market top and presented a formula for establishing the validity of this hunch (see the strategy section of the "Stock Indexes" article in our July issue). These conditions never came about, opening the possibility that the break was merely a first warning that the bull market was growing long in the tooth.

The dazzling technology sector had "broken," the old generals had passed on. But perhaps unaware of the momentous implications of such an event, the troops continued to rally. We recognized their enthusiasm and joined the bandwagon at a fortunate intersection (Sept. 1, at around 562.65, basis the September '95 S&P contract). What's next?

The bull market appears to have entered its final stage. Our short-term consensus indicators — reflecting moderate but not excessive bullishness — have little value, as they merely reflect sentiment for the shortest possible horizon. Long run, the American public is absolutely sold on the idea of equities as a first-class investment, and the continuing mutual fund mania proves it.

NASDAQ, where volume regularly exceeds the NYSE's by over 25%, has risen since its 1974 lows by almost 1,800%. Currency-adjusted, the NASDAQ bull market nearly matches the greatest financial bubble of our time, the 25-year Japanese market that peaked in 1989 (see Chart 1).

As we know, the collapse of the Nikkei foreshadowed a painful and still continuing economic contraction. Given the much greater importance of the US equity market relative to GNP than its Japanese counterpart, should we begin to worry about the fallout of the inevitable crash?

While these extremes of bullishness guarantee an eventual stock market collapse, we confess to be at a loss in divining what will trigger this event. Contrary to our expectations, inflation thus far has not been a problem: The consumer price index was up merely 0.1% in the latest month and just 2.6% in the latest year. Incredibly, revised second-quarter data showed non-farm productivity up a stunning 4.8% from an originally reported 3%, while unit labor cost showed a decline of 1.2% rather than a gain of 0.6%. Coming in the fifth year of an expansion — typically a time of falling productivity — the gain was the biggest in nine years. And while the CRB index has managed to break out of its 15-month consoli-

dation, other indexes more weighted with industrial commodities have been falling. The Journal of Commerce Spot Index is at a seven-month low, and the annual growth rate has just turned negative.

If an inflationary boom is not on the horizon, can the stock market frenzy be foreshadowing a depression of sorts? We do know that relative and absolute debt levels are very high, in the US (see Chart 2) and abroad. The extraordinary debt burdens of the household and government sectors may force a significant retrenchment in consumption in the period ahead. Already, nearly all of the major OECD governments have moved towards "sustainable" debt ratios, implying higher taxes (and thus impacting disposable personal income) and a deceleration in spending. Should consumers in the major industrial centres become uncomfortable with their high level of debt, consumption will suffer.

It may still be too early to tell. But one thing is certain: The coming crash, unlike the 1987 experience, will signal difficult years ahead.

STRATEGY: *We will attempt to fine tune the exit. In the meantime, raise stops to 570.00, basis December '95 S&P, close only.*

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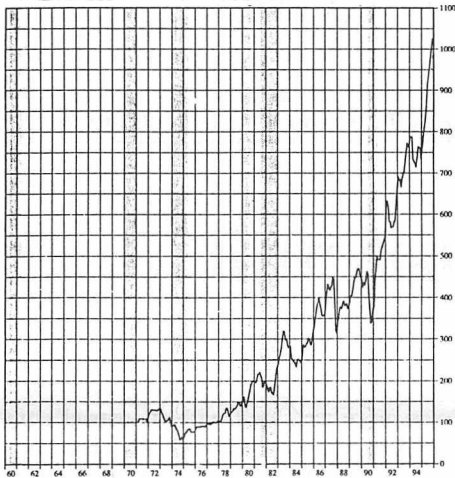
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Contributions by Albert D. Friedberg, Dr. Steve H. Hanke, Robert D. Laurent, Sholom Sanik and Peter O'Sullivan.

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

Chart 1

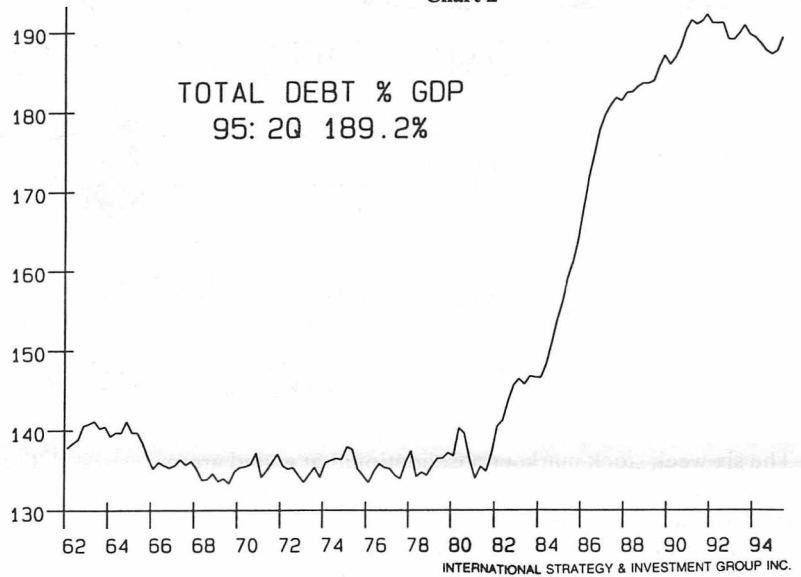
NASDAQ OTC Composite Index 1970-1995



Source: The Business Picture.

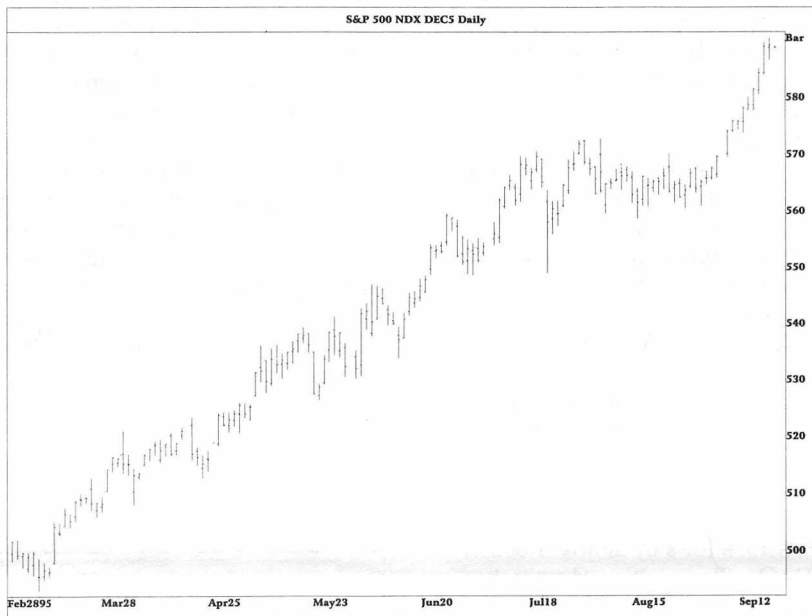
Chart 2

TOTAL DEBT % GDP
95: 2Q 189.2%



INTERNATIONAL STRATEGY & INVESTMENT GROUP INC.

Chart 3



JAPAN

Shades of the '30s in Japan

by Robert D. Laurent

Japan's banking crisis, highlighted by yesterday's [July 31] run on the Cosmo credit union, and the related economic problems are eerily reminiscent of the situation faced by the U.S. in the early 1930s.

In both instances, unprecedented loan losses put the banking system at risk. In both instances, the monetary authority responded to the economic problems by lowering short-term interest rates to historically low levels. Then, having engineered record-low interest rates, in both instances the

central bank declared itself unable to foster further reserve and monetary growth in light of weak loan demand.

Writing on this page [The WSJ] on May 29, Kengo Inoue, deputy director of research and statistics at the Bank of Japan, resorted to a metaphor straight out of the 1930s. He argued that having pushed interest rates to record low levels, the Bank of Japan is powerless to induce banks to seek more reserves than they can profitably lend out: That would be like "pushing on a string."

Purchasing Securities

This is correct only in one sense. The BOJ cannot create more reserves and still maintain its target interest rate. But as long as it is willing to allow short-term rates to seek their own level, the bank can always increase the supply of reserves in the banking system simply by purchasing securities. So long as these purchases are not from commercial banks, they directly increase the money stock, since the proceeds end up as deposits in commercial banks. Even when loan demand is weak, banks will invest these reserves in existing assets, expanding the money supply and lowering interest rates.

The problem for the Bank of Japan, as it was for the Fed in the early 1930s, lies in mistakenly equating the low level of interest rates with an accommodative monetary policy. Again, the similarities are striking. Japan's overnight call money rate hovers today at an all-time low of 0.75%. In the U.S. of the early 1930s, T-bill rates fell to a record low of under 0.25%.

But surely, it will be argued, if lower interest rates were going to help the Japanese economy, they would have helped by now. In reality, the level of interest rates is a misleading indicator for monetary policy under the sort of conditions Japan now faces. When banks are under severe financial stress, when asset prices are falling sharply, when business conditions and consumer confidence are weak, the behavior of money is a much better indicator. But even then, the proper monetary indicator is a broad measure of money.

Mr. Inoue himself pointed to the behavior of the Japanese monetary base (a narrow measure that includes currency plus bank reserves) to support the argument that the BOJ has been running a stimulative money policy. Japan's monetary base has indeed been growing at an accelerating, though low, rate over the last three years. But this raises probably one of the least appreciated lessons of the U.S. in the 1930s.

As Milton Friedman and Anna Schwartz document in their book, "A Monetary History of the United States," between October 1929 and March 1933 the U.S. monetary base actually grew by 4.1% a year. This was about the same as its previous 4.3% growth in the year ending October 1929. Looking just at the monetary base, it would seem that monetary policy had been almost as accommodative during the Great Depression as it was before.

But the monetary base, primarily comprised of currency and little influenced by bank deposits, reflected none of the severe financial strain being felt by the U.S. banking system. A truer reflection of the impact of banking system stress on monetary policy was the behavior of a broad monetary aggregate including total bank deposits. Between October 1929 and March 1933, this broad aggregate fell by 13.0% annually, compared with a growth rate of 3.9% in the previous four-year period.

To understand the extended Japanese recession and its weak rebound, it is necessary to look at the behavior of the corresponding Japanese broad money measure: M2 plus bank CDs [Chart 4]. From a 12.9% annual rate in the first half of 1990, growth in this broad monetary aggregate fell to an alltime low of negative 0.5% in late 1992, rebounding recently to a pace of only 2.7%. Though less dramatic than the U.S. example,

these figures still present a sharp fall-off in money creation.

The major difference between present-day Japan and the U.S. in the early 1930s is the existence of deposit insurance. If Japanese depositors were truly worried about the safety of their deposits, the Japanese economy would resemble the U.S. economy of the 1930s, not just in qualitative terms but in quantitative terms as well. Were it not for deposit insurance, the Cosmo run would have generated a chain reaction in which Japanese would be massively withdrawing their savings from the banking system, leading to weaker money growth, much weaker economic activity and much greater deflation.

But perhaps the most striking similarity of all between the U.S. situation of the 1930s and the current Japanese situation lies in the motivation of the monetary authority. When the Federal Reserve and the Bank of Japan first began to raise interest rates in 1928 and 1988, respectively, they were not responding to the usual monetary policy concern of rising general inflation; in both cases inflation was well under control. Instead, the monetary authority was concerned about a sharp rise in specific asset prices — stock prices in the "roaring twenties" in the U.S., and stock and real estate prices in Japan's "bubble economy" — which were considered to be the result of excessive speculation.

A solution to general price inflation requires only disinflation, or a decrease in the rate of inflation. But a solution to excessive asset prices requires actual deflation, or falling prices. If banks have extended loans to purchase these assets (using the assets as collateral) — or even more critically in the case of Japan, if they own the assets directly — a solution to a problem of excessive asset prices must necessarily involve large loan losses and severe financial stress for banks.

This explains why, in these two episodes, even cuts in short-term interest rates to historically low levels did not insure recovery. Indeed, it is ironic that in these two episodes in which monetary policy so clearly achieved its original objective — leading arguably to the two greatest stock bear markets of the 20th century — the ultimate conclusion should be that monetary policy is ineffective.

It was extremely effective in bursting both asset bubbles, and can now be effective in pulling Japan's real economy out of its doldrums — provided policy makers understand that, when the banking system is under severe stress, the level of interest rates is a very misleading indicator. With the recent appearance of general deflation in Japan making it even more attractive to hold money rather than spend it, the Bank of Japan should aggressively push reserves into the banking system, allowing short-term rates to fall as far as necessary to produce vigorous growth in its broad monetary aggregates. Such a policy seeks to stimulate domestic demand in yen to help offset export weakness caused by a strong yen. This process could be aided by long-overdue tax and regulatory cuts that would stimulate domestic consumption. Let us hope that the Cosmo run is the needed impetus to put this plan in motion.

Mr. Laurent is a senior economist at the Federal Reserve Bank of Chicago. Reprinted with permission of The Wall Street Journal © 1995 Dow Jones & Company, Inc. All rights reserved.

COMMENTARY

The accompanying article illustrates rather well some of the confused thinking surrounding the Japanese economic situation.

Author Robert D. Laurent argues forcefully that the level of interest rates is not a proper indicator of monetary accommodation (or tightness for that matter). Rather, the central bank should concentrate on the growth of money, primarily the broad money supply. Laurent says, "even when loan demand is weak, banks will invest these reserves in existing assets, expanding the money supply and lowering interest rates." Even if we were to grant that Japan's low level of interest rates cannot be equated with an accommodative monetary policy, how much lower does Laurent think interest rates can go if the BOJ were to pursue a money supply target?

Surely, short-term rates, now at 3/8%, could not go much lower nor could they, if they did, assist unwilling borrowers any more than they are doing now. Certainly, long-term rates would rise from their historic and unheard of 2.75%-3.15% level in anticipation of future inflation.

What, then, can be hoped for, at least in terms of rates, by shifting to a policy that will actively increase the money stock?

What Japan needs is a little bit more deflation, rather than a little bit more inflation. Increases in the money stock will only delay the inevitable liquidation of still overpriced assets. The collapse of real estate prices, and land in particular, will go a long way towards increasing household purchasing power, provided the BOJ prevents, or at least successfully counteracts, a generalized run on deposits from actually shrinking the money stock (as occurred in the US between 1929 and March

1933, when the broad money supply fell by 13% annually).

Increases in the money stock only swell nominal income; they have no effect on real income. After adjusting via inflation, real income remains the same. Something similar happens to the other variables, real interest rates, and the real value of the yen.

A fiat increase of money supply will raise the nominal level of interest rates, leaving real rates unchanged after adjusting for anticipated inflation and will lower the nominal value of the yen in the foreign exchange markets but leave its real rate of exchange unchanged once a rise in prices is taken into account.

Japan must bite the bullet. Real economic recovery can only begin to take place once the losses have been fully recognized. Only now, after five long, agonizing years, has some semblance of realism crept into official circles. As an example, in recent days the Ministry of Finance disclosed that problem loans at Japan's eight home mortgage companies were nearly \$24 billion higher than industry analysts had believed and that roughly 75% of their total non-performing loans were in danger of being irrecoverable.

Let us hope that this week's fiscal package deepens previous deregulatory moves, provides stimulation via tax cuts and tells the Japanese public the sad truth: Losses are real, they are huge, and whenever possible, they will be charged to those who speculated incorrectly. The rest of the losses will be socialized. Yes, Virginia, we are in a depression, and the sooner we admit it, the faster we will come out of it.

Chart 4

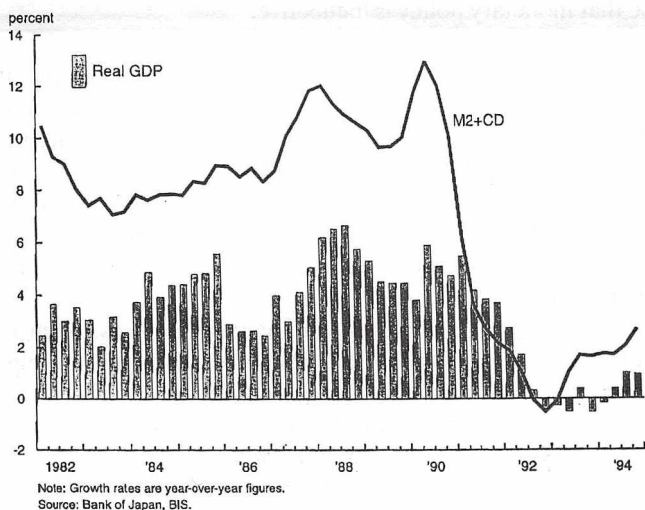


Chart 5



CANADIAN DOLLAR

Friendly, but sidelined

Oui or Non, the Canuck buck is in the early stages of a powerful secular uptrend.

Federal and provincial governments are in retreat, forced by necessity rather than ideology. Little wonder that Quebec separatists are moving even closer to their go-it-alone dream. The fat dividends from Ottawa are shrinking and are about to disappear altogether. And while an independent Quebec may pursue a dirigistic and nationalistic economic policy (for a while, anyway), the rest of Canada has seen the light.

Privatization, deregulation, and cutting spending are the order of the day. It is still a bit timid, but no doubt it will gain momentum. In the meantime, the cheap dollar will begin to attract capital to these shores, and the 15%-20% purchasing power parity gap will begin to close.

Bond investors should take note of the fact that the Canada/US 10-year spread (see Chart 6) has recently widened

to 190 basis points, implying a 10-year forward discount for the Canadian dollar vis à vis the US dollar of better than 20% on top of the *current* discount. In light of today's fundamentals, medium-and long-term Canadian bonds are an outstanding bargain for US-based investors.

STRATEGY: *We were profitably stopped out of our long Canadian dollar positions in the most recent setback.*

Thanks to the upcoming Quebec referendum, volatility has soared, making it inconvenient to carry a speculative futures position. We maintain a very friendly attitude to the Canadian dollar and will look to reenter the market once the political uncertainty has been resolved (one way or the other).

Long-term US-based bond investors, however, should make use of the unsettled conditions in the 5-year to 10-year area and begin accumulating sizeable positions.

Chart 6

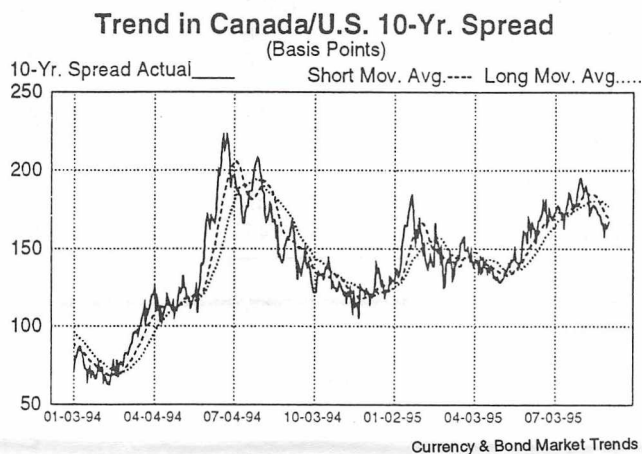


Chart 7



PRECIOUS METALS

Getting ready for the upside

Led by fast growing jewellery fabrication in India and South East Asia and the surge in Japanese investment demand for bars, physical demand for gold reached a record level in the first half of this year, according to Gold Fields Mineral Services (see Chart 8).

It is noteworthy that the only increases in supplies continue to be official sector sales, a total of 244 tonnes during the period, including 175 tonnes from Belgium, and producer

forward sales, which added some 211 tonnes of accelerated supply to the market.

While on the subject of forward sales, at the end of August, Gengold, a division of the South African Gencor Mining and Metals Group, completed the biggest-ever and longest-lasting gold hedging program. Gengold's hedge covered 2.9 million troy ounces, or more than 90 tonnes of gold over six years. In exchange for a floor price for gold equiva-

lent to about \$385/oz. starting in December this year and rising to \$465/oz. in September 2001, Gencor will participate in 70% of any increase in the gold price above the levels it has hedged.

Australian gold producers have also been heavy users of the forward sale mechanism, increasing the level of forward sales by 38 tonnes since March. This takes Australia's forward sales to 558 tonnes, compared with their estimated production of 256 tonnes for the year ending June 30, 1995.

While the size of these activities demonstrates the usefulness and vitality of the forward sale mechanism, it also explains the extraordinary stability of the price of gold in the face of soaring demand. Current production will increasingly have a diminishing impact on prices, as it will merely serve to repay existing loans.

Chart 8 shows an extremely wide and widening gap between current mine production and demand (737 tonnes for the first half of 1995 versus only 394 tonnes in the first half of 1994). Current prices will not resist the widening gap for much longer.

While both gold and silver remain locked into trading ranges, their performance relative to other metals and industrial commodities has improved. At the same time, sentiment and public participation remain subdued, a hopeful sign that we are nearing an upside resolution.

STRATEGY: You are long December gold as per our flash update of Sept. 12. Place initial stops at 385, close only.

One new recommendation: Buy December silver at the market, placing initial stops at 5.15, close only.

Chart 8

World Gold Supply and Demand (tonnes)

	1st half 1995	1st half 1994		1st half 1995	1st half 1994
Supply			Demand		
Mine production	1,110	1,116	Fabrication		
Official Sector Sales	244	-4	Jewellery	1,391	1,147
Old Gold Scrap	282	286	Electronics	98	90
Forward Sales	152	-	Official Coin Sales	56	32
Options hedging	59	17	Other	97	92
			Bar hoarding	151	115
			Gold Loans	12	27
Disinvestment	-	94	Forward Sales	-	7
Total	1,847	1,510	Investment	42	-
			Total	1,847	1,510

Source: GFMS

Chart 9

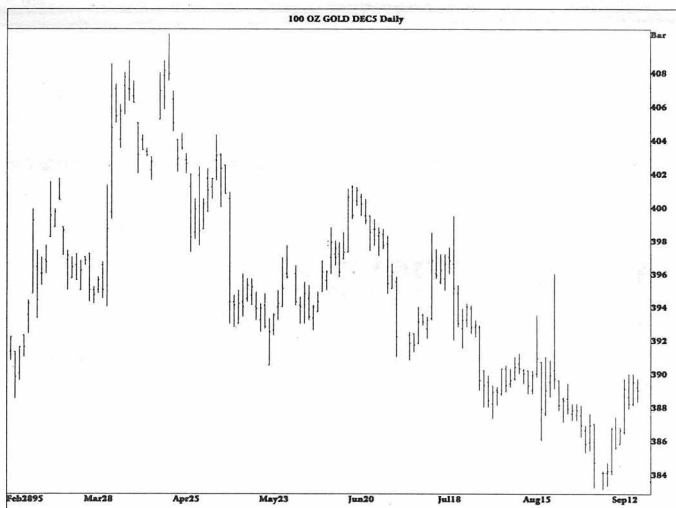


Chart 10



SOFT COMMODITIES

Soymeal, cocoa, wheat

Soy complex

Of the three major US crops — wheat, corn, and soybeans — only soybeans were planted on more acreage in 1995 than in 1994, and at that, only as an afterthought. The spring was so wet that a lot of corn never made it into the ground before the planting deadline, giving farmers little choice but to plant soybeans, which can be planted as late as early June, or let their fields go idle. As it is, even with the unexpected acreage, the crop will be 2.285 million bushels, down from 2.558 million bushels in 1994, owing to a sloppy yield of 37 bushels per acre, down from 41.9 in 1994. Consumption will remain fairly constant, registering a small gain over last year but with production falling, stocks continue to be depleted.

Soybean oil has been the strongest of the group in the past couple of years, mainly because of poor palm oil crops in Asia causing strong demand. But since palm oil crops have staged a strong recovery this year, beanoil has given up its long running backwardation and is not nearly as interesting as its sister, soybean meal.

It has been long known that a price chart of soybean meal, save for the occasional palpitation, looks very similar to the EKG of a healthy human's heart: rather boring. Unlike the volatility seen by the grain markets in neighbouring futures pits, meal has not often veered very far, and when it has, not for very long from the \$180 per ton mark.

Production and consumption of this livestock and poultry feed has been running neck and neck for the last decade, leaving the smallest carryover of any commodity we know of, at about 4% of consumption. This has obviously been an acceptable state of affairs as evidenced by the stable price. However, there are grounds to believe that this complacency can be dangerous.

As corn flirts with \$3.00 a bushel, meal starts looking rather attractive to people who have to feed their animals. Since 1993, the price of corn has gone up about 60% vis à vis meal; that is as expensive as corn has been in a decade.

Soybean meal has a very high protein content and is fed primarily to poultry and hogs. In North America and Europe, the typical ratio fed to fowl is 20% meal and 80% corn. In most of the rest of the world hardly any meal is used, but as corn becomes more expensive, the switchover potential in economies that are becoming more sophisticated is explosive. Furthermore, despite all the hype in the grain markets about tightening supplies, the only tightening seen in our trusty futures contracts spreads is in meal. This market may be a sleeper no longer.

STRATEGY: Buy December '95 soymeal at the market and place stops at 185, close only.

Chart 11



Cocoa

October 1 will mark the start of the 1995-96 cocoa year. As well, it will usher in the fifth consecutive year of production/consumption deficits. The International Cocoa Organization (ICCO) projects a deficit of 67,000 tonnes, down from the 1994-95 deficit of 170,000 tonnes. Although the size of the deficit is shrinking, rising consumption is eating into global stocks.

Two years ago the stocks to grindings ratio stood at 55%. By the end of next year, it should be down to 43%, a number that represents a foray into a discomfort zone for large users of cocoa. If that is troubling, consider that the ICCO projects deficits right through the end of the decade, which would leave us with a stocks to grindings ratio of 29.8% by the year 2000. Consumption is rising in every region of the world except for Russia and the former Soviet Bloc.

Analysts have sought to explain the boring and gradually eroding price action on seasonal factors: A particularly hot Northern hemisphere summer discouraged consumption of chocolate products and sent people scurrying for cooler, wetter snacks. This undoubtedly has been a factor and could be seen in the sluggish buying patterns of European processors as their inventories did not need much replenishing.

Another, more potent, bit of information could help explain the recent weakness. It has come to light, just in the last few days, that arrivals of cocoa in the Ivory Coast, the world's largest producer, is up to almost 880,000 tonnes, which is about 20,000 tonnes more than even the most optimistic estimate.

We don't think that the final 1994-95 deficit figure will be affected by much, because at the same time, Nigeria and

Ghana will suffer an unexpected setback. August has seen lot of excess precipitation in those countries, which delays harvest because the beans, once off the trees, must be dried properly, which, owing to the wetness cannot be done. So they leave the beans on the trees, making them susceptible to the cocoa Scrooge, Blackpod disease.

So what's gained in the Ivory Coast could be lost in Nigeria and Ghana. Nonetheless, the phsycological effect of seeing the world's largest producer, Ivory Coast, put together a late-inning rally has given more reason for already passive buyers to hold back and put a damper on prices, albeit temporarily, in this budding bull market.

STRATEGY: Remain long, with stops at 1270, basis December, close only.

Wheat

The September USDA crop report revised the world wheat crop to 532 million tonnes from an early summer estimate of 543 million tonnes. Consumption was shown to be slightly lower as well at 546 million tonnes, down from 550 million tonnes.

Global consumption has levelled off since 1990 but production is running about 2.5% below the average of the decade, enough to draw stocks down to 100 million tonnes, or 18% of consumption. As recently as 1993-94, the carryover was 25%.

The situation has not gone unnoticed as prices have risen persistently. The question now becomes: Will buyers pay the price or create an absence of bids that will cause a sharp setback? Potential suitors, like the Russians for example, have been releasing statements to the press indicating that the money is simply not available, especially at these prices, in a, thus far, vain attempt to drive prices down to more attractive levels.

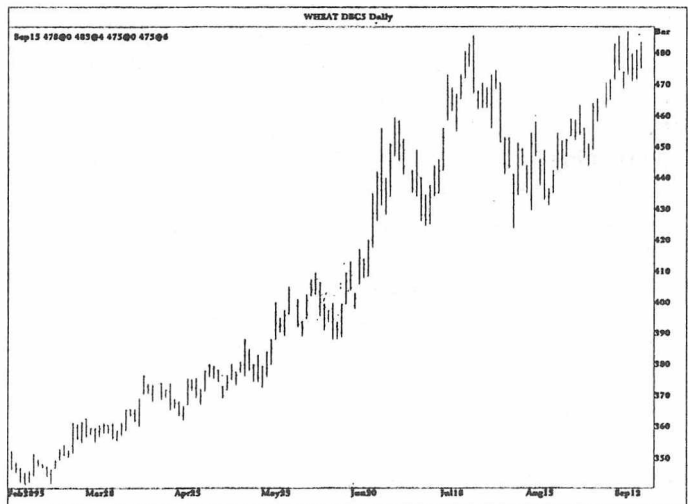
In fact, US exports this week were 695,300 tonnes, compared with 872,000 last week. However, this should be viewed in the context of year-to-date exports. The marketing year for US wheat starts in June. Through August 31 exports have totalled 8.328 million tonnes compared with 6.704 million tonnes at the same time last year, an increase of 24%.

The USDA crop report included a call for a drop in exports from last year, obviously not properly accounting for the torrid pace of what is actually transpiring. If we were to project US exports to continue at this clip for the balance of the year, "you ain't seen nothin' yet."

STRATEGY: Because our technical indicators have turned negative, we have advised liquidating long positions, accepting handsome profits. Stand aside for now.

– Sholom Sanik

Chart 12



FRIEDBERG CAPITAL MARKETS

Unemployment and convertibility

Steve H. Hanke

The level of confusion and disinformation about Argentina is truly astounding. It comes from three sources: Journalists who don't know any better, analysts who should know better, and hedge fund managers who will spin any tale as long as it creates volatility.

Among other things, this trio of spin doctors is responsible for the false belief that the peso is overvalued and that it will eventually have to be devalued. As I argued in the July issue of *Friedberg's Commodity & Currency Comments*, this assertion is little more than nonsense. Argentine exports are growing at over 40%, when measured on a year-over-year basis. The real exchange rate — when correctly measured by using wholesale prices — has not appreciated since Argen-

tina installed its currency board-like system in April 1991. Furthermore, no currency board has ever devalued its currency.

Although the overvaluation assertion has been put to rest, these spin doctors are a Hydra of sorts. In their latest witch hunt, the spin doctors assert that because unemployment is high in Argentina, the government will be forced to devalue. More nonsense.

When Carlos Menem was elected president in 1989, Argentina was an economic joke. For over a year, the Menem government tried in vain to begin cleaning up Argentina's economic mess. Then, on April 1, 1991, the president and his team, which was led by Domingo Cavallo and Roque Fernandez, installed the so-called convertibility system. Un-

der this monetary system, the peso freely trades at a fixed rate of one peso per dollar and is fully backed by US dollar-denominated assets.

This monetary system depoliticized monetary policy and gave the monetary authorities credibility. It also broke the back of hyperinflation and stabilized the real exchange rate, which had been fluctuating wildly for decades. By dramatically reducing the foreign exchange rate risk of investing in Argentina and increasing investor confidence, the new monetary system stimulated foreign capital inflows. The convertibility system also forced discipline on the fiscal authorities, because the monetary authorities could no longer make loans to the government.

From a broader, strategic, point of view, the convertibility system gave President Menem and his team much-needed credibility. This credibility allowed the government to introduce far-reaching structural reforms, which were aimed at modernizing and liberalizing Argentina's beleaguered and distorted economy. Specifically, the import substitution model was thrown overboard, and the economy was opened to foreign and domestic competition. In addition, a massive privatization program was undertaken. In consequence, an economic boom followed, and until the Mexican peso debacle, the economy produced both very high rates of GDP and job growth.

However, even though total employment has grown since 1991, unemployment has increased significantly, particularly for workers with low skill levels. To put the unemployment problem into perspective, consider that it averaged 3.5% in 1980-84 period; increased to 5.5% in the 1985-89 period; and jumped up to 7.6% in the 1990-94 period. At present, unemployment is almost 19%.

Why has the unemployment risen so rapidly in the post-April 1991 period, particularly in light of the economic boom that has generated an average GDP growth of over 7% annually? The massive privatizations transformed a great deal of redundant employment (disguised employment) into temporary real unemployment. The opening of the economy also increased unemployment, because many workers who had skills suited for a closed economy were no longer in demand. Furthermore, the reduction in tariffs reduced the price of capital relative to labor, because most capital goods were imported, and that continues to be the case. In consequence, capital was substituted for labor, adding to the unemployment rolls. In addition, unemployment insurance, financed by a payroll tax, was introduced. This reduced the cost of not working and thereby increased the ranks of the unemployed.

If these factors weren't enough, Argentina's economic boom attracted foreign workers, particularly those with low skills, adding as much as four to five percentage points to the official unemployment figures.

Argentina's unemployment problem is, therefore, the result of a shakeout in and restructuring of the economy. The unemployment created by this economic restructuring has been seriously exacerbated by the inflexibility of Argentina's labor market. Indeed, there are serious supply-side impediments to a smooth functioning, competitive labor market. Specifically, the labor market remains highly regulated and heavily taxed. Labor unions still retain a great deal of monopoly power, because of their privileges and immunities. This contrasts with Chile, for example, where unions operate, but in a competitive context. In addition, tax policies in Argentina drive a huge wedge between what employers pay for labor and what workers receive. The wedge amounts to almost 50%, hinders labor market flexibility, and dramatically retards job creation. Laws governing severance pay and workers compensation for on-the-job injuries also add to the problems of labor market inflexibility in Argentina.

Argentina's unemployment problem is a supply-side problem, not a demand-side problem. In order to rectify Argentina's labor market problems, President Menem and Minister Cavallo have proposed a package of labor market reforms. These supply-side initiatives will be the hallmark of President Menem's second term. When implemented, these reforms will introduce flexibility and competitiveness into the labor market, which will alleviate Argentina's severe unemployment problem.

The spin doctors are barking up the wrong tree. Again. The convertibility system is not the source of Argentina's unemployment. Indeed, this monetary regime serves Argentina well and has been, on balance, a job creator. The convertibility system keeps the politicians' larcenous hands off the money supply levers. In Argentina, the convertibility system is the only politically practical way to achieve this discipline. Without convertibility, stability would be lost. And although stability might not be everything, everything is nothing without stability. President Menem and Minister Cavallo know this. That is why the convertibility system will be retained and why there will not be a devaluation.

Dr. Hanke is Vice Chairman of Friedberg Mercantile Group, Inc., and adviser to Argentina's Minister of Economy Domingo Cavallo. Dr. Hanke also serves as president of Toronto Trust-Argentina, this year's top-ranked mutual fund in Argentina.

FRIEDBERG CAPITAL MARKETS

TWA rises from the ashes

Security: Senior secured bonds

Coupon: 10%

Maturity: November 3, 1998

Status: Exchanged

After creditors' acceptance of a prepackaged restructuring, TransWorld Airlines (TWA) has emerged from chapter 11 with a more competitive cost structure and promising second-

quarter results. With delays in the restructuring process and poor first-quarter earnings, the company announced second-quarter earnings of \$5.2 million, up from a \$58.2 million loss for the same period in 1994 and a \$122.8 million loss for Q1 1995. The operating margin has increased significantly from 1995 Q1 to 1995 Q2, where it has gone from a negative 11.02% to a positive 6.32%. Lower operating costs are due to cost-cutting measures implemented by management as well as

labor concessions gained through negotiation.

Recent results also show system load factors (revenue passenger miles/available seat miles) have increased over July and August 1995, 2.9% and 2.7% respectively. The YTD at August 1995 system load factor is 66.9%, up from 64.5% for YTD at August 1994. The increase in load factor implies that more seats are being filled on TWA flights.

In the short term, we expect the company to meet its targets for the following reasons:

- System load factors should continue to increase through Q3, which is the peak season for airlines. Also, with more efficient aircraft deployment and the removal of unprofitable routes, one should see not only increased load factors but increased "revenue passenger miles" and "yields" as well.

- The company should maintain its operating margins through cost-cutting measures implemented as part of the reorganization.

- The business environment is "airline friendly." It is characterized by low inflation, relatively low fuel prices and the absence of air fare wars with continued economic growth expected.

We believe that TWA will continue to show improvement; however liquidity remains a concern with projected cash balances of \$128 million by year end 1995. This is approximately the amount of interest expense projected for the coming year. A longer-term outlook will depend on a continued favorable business climate, the relative short-term success of the new strategy and the company's performance with respect to Q3 traffic targets.

Our June issue provided a summary and description of what was to be received for each \$1,000 face value of 10% note. As key dates draw closer and more information becomes available, the final value of the agreement can be estimated. For example, the company recently announced the equity rights subscription price, which was previously unknown and required to estimate the value of these rights. We feel the final value of the 10% notes should fall within the \$870-\$910 per \$1,000 face value range.

The new 12% notes have a YTM of approximately 20%, compared with industry yields of 8%-10% for similar times to maturity. This indicates a 1000 basis point risk premium is associated with TWA's current situation with respect to the reorganization and the current level of leverage. Given 100% collateralization on these notes and the airline showing signs of adhering to a more competitive cost structure, we look for a decrease in required yield and a corresponding rise in the bond's price.

STRATEGY: Hold on to the new 12% notes while waiting for Q3 results. We believe that the stock is fairly valued; therefore a liquidation of the stock and equity right positions is recommended. This strategy will reduce the cost base of the original 10% notes and the risk associated with the package by monetizing a portion of its current value. We will maintain the exposure on the new 12% notes and look for both an improvement in company fundamentals as well as a more favourable risk assessment from market participants.

— Peter O'Sullivan

Chart 13 – 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 September 15, 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	5.55%		VEB '96 yields 9.19% (DM/US 1.5378)								ESCOM '96 yields 13.69% (SAR/US 0.2529)	NIB '96 yields 11.77% (ITL/US 1.7017)		
2 year	5.72%				World Bk. '96 yields 0.34% (JY/US 93.3241)	Denmark '96 yields 5.52% (DKr/US 5.7263)	Sweden '96 yields 6.39% (US/BP 1.5330)	Cr. Lyon '96 yields 6.10% (FFr/US 5.1523)			R.B.C. '97 yields 6.95% (CDN/US 1.3995)			
3 year	5.80%													
4 year	5.85%		Argentina '98 yields 7.86% (DM/US 1.6027)	G.E. '98 yields 3.69% (SF/US 1.1096)										
5 year	5.91%	Tranz Rail '99 yields 9.19% (US/NZ 0.5646)												
6 year	5.98%								UK '01 yields 6.99% (US/ECU 1.1920)				BIC V '01 yields 19.19% (ARG/US 2.0235)	
8 year	6.12%													
9 year	6.19%													
Spot Exchange Rate	—	0.6576	1.4865	1.205	103.6	5.748	1.5525	5.1155	1.2618	1.3675	0.2724	1.607	1.00	4.4262

*For example, since a US\$-based investor would receive 328 basis points (919-591) by holding the Tranz Rail NZ\$ bond, the NZ/US can depreciate to .5646 from the present spot exchange rate of .6576 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 14 – FOREIGN CURRENCY BONDS

DATE: September 15, 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
DEUTSCHE MARK DENOMINATED BONDS					
Bank of Nova Scotia 5 5/8% 7/5/96 RRSP eligible	99.80	100.65	4.47		May-07
World Bank 5 7/8% 4/02/97 RRSP eligible	102.25	-	-		Feb-04
World Bank 7 1/4% 13/10/99 RRSP eligible	106.40	107.25	5.22		Oct-13
World Bank 9% 13/11/00 RRSP eligible	116.35	117.20	5.11		Nov-13
Kingdom of Denmark 6 1/8% 15/04/98	102.30	103.15	4.78		Apr-15
Argentina 8% 5/10/98	99.50	-	-		Oct-05
Bk. Foreign Eco. Affairs 7% 29/3/96	97.90	98.75	9.19		Mar-29
Kgdm. of Spain (6 Mo. LIBOR-1/16) 29/6/02 (semi)	99.31	-	-	4.5625	Dec-29
ITALIAN LIRA DENOMINATED BONDS					
Nordic Inves. Bk 12 3/8% 19/04/96	99.15	100.00	11.77		Apr-19
SWISS FRANC DENOMINATED BONDS					
General Electric 4 3/4% 2/7/98	101.90	102.75	3.69		Jul-02
DANISH KRONE DENOMINATED BONDS					
Kgdm. of Denmark 9% 15/11/96	102.90	103.75	5.52		Nov-15
ECU DENOMINATED BONDS					
United Kingdom 9 1/8% 21/02/01	108.45	109.30	6.99		Feb-21
BRITISH POUND DENOMINATED BONDS					
Kgdm. of Sweden 8 3/4% 29/5/96	100.60	-	-		May-29
FRENCH FRANC DENOMINATED BONDS					
Credit Lyonnaise 9 1/2% 23/12/96	103.10	103.95	6.10		Dec-23
JAPANESE YEN DENOMINATED BONDS					
World Bank 5 3/4% 7/8/96 RRSP	103.90	-	-		Aug-07
CANADIAN DOLLAR DENOMINATED BONDS					
Ontario Hydro 10 7/8% 8/01/96 (semi) RRSP eligible	100.65	101.90	4.34		Jan-08
Eksportfinans 7 3/4% 5/11/97	99.80	-	-		Nov-05
Royal Bank of Canada 9 1/8% 7/1/97 RRSP eligible	101.30	-	-		Jan-07
Ontario Province 10 5/8% 15/7/98 RRSP eligible	106.85	108.10	7.32		Jul-15
SOUTH AFRICAN RAND DENOMINATED BONDS					
ESCOM 12% 1/5/96 (semi)	98.15	99.00	13.69		Nov-01
AUSTRALIAN DOLLAR DENOMINATED BONDS					
Commonwealth Bk. of Australia 9 3/4% 15/5/96	100.95	101.80	6.65		May-15
NEW ZEALAND DOLLAR DENOMINATED BONDS					
World Bank 12.5% 25/7/97 (semi) RRSP eligible	106.90	107.75	7.90		Jan-25
New Zealand Gov't 10% 15/7/97 (semi)	102.20	-	-		Jan-15
New Zealand Gov't 8% 15/7/98 (semi)	99.75	100.60	7.75		Jan-15
Fletcher Challenge 10.75% 15/12/97 (semi)	102.20	103.05	9.20		Dec-15
Fletcher Challenge 10.15% 30/11/98 (semi)	101.80	102.65	9.17		Nov-30
Tranz Rail Ltd. 10% 15/10/99 (semi)	101.85	102.70	9.19		Oct-15
DB Group 7% 30/6/96 (semi) matures @ 85	85.10	85.95	10.54		Dec-30
Seabil Ltd. 9% 27/6/99 (semi)	86.95	87.80	13.62		Dec-27
ARGENTINEAN PESO DENOMINATED BONDS					
BIC V Fixed/Floating 1/5/2001 Callable	57.00	59.00	19.19	57.5	4th day of mth.
Bocon Pre 1: 1/4/2001	66.25	68.25	25.98	131.074	May-01-97
U.S. DOLLAR DENOMINATED FIXED CONV. BONDS					
Burnup & Sims 12% 15/11/00 CV@16.79 p/sh (semi)	97.25	98.75	12.33		Nov-15
Atari Corp. 5 1/4% 29/4/02 CV@16.31 p/sh	55.25	56.75	16.43		Apr-29
Coeur D'Alene 6% 10/6/02 CV@ 26.00 p/sh	91.25	92.75	7.40		Jun-10
Glycomed 7 1/2% 1/1/03 CV@14.06 (semi)	71.25	72.75	13.49		Jan-01
California Microwave 5 1/4% 15/12/03 CV@28.44 p/sh (semi)	106.25	107.75	4.13		Dec-15
U.S. DOLLAR DENOMINATED FIXED RATE BONDS					
World Bank 7 1/8% 27/9/99 (semi) RRSP eligible	103.75	104.60	5.82		Sep-27
Farm Credit Corp 7 3/4% 10/06/96 RRSP eligible	100.50	101.35	5.68		Jun-10
T.W.A. 10% 3/11/98 (semi)	-	-	-		N/A
U.S. DOLLAR DENOMINATED FLOATING RATE NOTES					
Kgdm. of Denmark 25/3/97 (Gold call, JY put),(semi)	87.90	88.90	-	8.45	Sep-25
United Kgdm. 30/9/96 3 mo.LIBID-1/8 (qty),callable @100	99.85	100.15	-	5.75	Sep-30
Bocon 1/4/01 (30 day LIBOR) starts paying May 1,'97	81.40	82.25	19.13		May-01-97
Argentina: Series L:FRB 31/3/05, 6 mo. LIBOR+13/16 (semi)	61.5	63	16.84	7.3125	Sep-29
GOLD (in ounces, at market prices, can also be held in your bond account) client eligibility determined at point of sale.					

Chart 15 – Recommended current portfolio allocations

1. 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, July 25, 1995:

Good afternoon for Tuesday, July 25. There are no changes or new recommendations. Have a great trading day.

Wednesday, July 26, 1995:

Good morning for Wednesday, July 26, 9:30 am. This is a flash update. Sell September copper at the market, presently trading at 133.40, placing initial stops at 136.00, close only. Have a great trading day.

Friday, July 28, 1995:

Good afternoon for Thursday, July 28. There are no changes or recommendations. The following is recap of this week's recommendations.

On Wednesday, July 26, we advised to sell September copper at the market, then trading at 133.40, placing initial stops at 136.00, close only.

Have a great trading day.

Tuesday, August 1, 1995:

Good afternoon for Tuesday, August 1. There are no changes or recommendations. Have a great trading day.

Wednesday, August 2, 1995:

Good afternoon for Wednesday, August 2, 5:30 pm. This is a flash update. Sell September S & P at the market, placing stops at 569.00, good anytime. Have a great trading day.

Friday, August 4, 1995:

Good afternoon for Friday, August 4. There are no changes or new recommendations. The following is a recap of this week's recommendations.

On Wednesday, August 2, via flash update, we advised to sell S & P at the market, placing stops at 569.00, good anytime. S&P opened on Thursday at 556.75. Have a great trading day.

Tuesday, August 8, 1995:

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

Friday, August 11, 1995:

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

Tuesday, August 15, 1995:

Good morning for Tuesday, August 15, 9:10 am. This is a flash update. Sell October crude oil at the market, placing stops at 1790, good anytime.

Tuesday, August 15, 1995:

Good afternoon for Tuesday, August 15. There are no changes or new recommendations. We repeat the flash update of this morning at 9:10 am, to sell October crude oil at the market, placing stops at 1790, good anytime. Have a great trading day.

Thursday, August 17, 1995:

Good morning for Thursday, August 17, 8:30 am. This is a flash update. Liquidate short September T-bond positions, at the market, presently trading at 110.07. Have a great trading day.

Thursday, August 17, 1995:

Good afternoon for Thursday, August 17, 3:45 pm. This is a flash update. Cover short S&P positions at the market, presently trading at 560.80, cancelling the 569.00 stop. Have a great trading day.

Friday, August 18, 1995:

Good afternoon for Friday, August 18. As there will be no newsletter for the month of August, what follows is a complete summary of all liquidations of open positions and new recommendations that remain outstanding since our last newsletter of July 19.

On Tuesday, August 15, via flash update, we advised to sell October crude at the market, placing stops at 1790, good anytime. October crude opened on Wednesday, August 16 at 17.22.

On Thursday, August 17, via flash update, we advised to liquidate short September T-bond positions, at the market, then trading at 110.07. For those who were short the September S&P, as per our flash update of August 2, at around 556.75, please note that we advised on Thursday August 17, to cover this position at the market, then trading at 560.80, cancelling the 569.00 stop. Have a great trading day.

Tuesday, August 22, 1995:

Good afternoon for Tuesday, August 22. There are no changes or new recommendations. Have a great trading day.

Friday, August 25, 1995:

Good afternoon for Friday, August 25. There are no changes or new recommendations. Have a great trading day.

Tuesday, August 29, 1995:

Good afternoon for Tuesday, August 29. There are no changes or new recommendations. Have a great trading day.

Friday, September 1, 1995:

Good morning for Friday, September 1, 8:50 am. This is a flash update. Buy September S & P at the market, presently trading at 562.65, placing stops at 555.50, good anytime. Have a great trading day.

Friday, September 1, 1995:

Good afternoon for Friday, September 1. We have two new recommendations.

We are revising our sell stop for December cocoa to 1270, close only, and for December wheat to 4.39, close only.

We repeat our flash update of 8:50 am this morning to buy September S & P at the market, then trading at 562.65, placing stops at 555.50, good anytime. Have a great trading day.

Tuesday, September 5, 1995:

Good afternoon for Tuesday, September 5. We have one new recommendation. Sell December copper at the market, placing stops at 13500, good anytime. Have a great trading day.

Friday, September 8, 1995:

Good afternoon for Friday, September 8. We have two new recommendations.

Our new stop on the Canadian dollar is 7327, close only, basis December. Our new stop on the S&P 500 is 560.00, close only, basis December. Have a great trading day.

Tuesday, September 12, 1995:

Good afternoon for Tuesday, September 12, 12:45 pm. This is a flash update. Buy December gold at the market, presently trading at 389.00. Have a great trading day.

Friday, September 15, 1995:

Good afternoon for Friday, September 15. We have one new recommendation: Liquidate December wheat at the market, cancelling the 4.39 stop.

This is a complete summary since our last market letter dated July 19, of all liquidations of open positions and new recommendations that remain outstanding.

On Thursday, August 17, via flash update, we advised to liquidate short September T-bond positions, at the market, then trading at 110.07.

On Friday, September 1, via flash update, we advised to buy September S&P at the market, then trading at 562.65, placing stops at 555.50, good anytime. On Friday, September 8, we revised our stops to 560.00, basis December, close only.

On Friday, September 1, we revised our sell stops on December cocoa to 1270, and December wheat to 4.39, close only.

On Tuesday, September 5, we advised to sell December copper at the market, placing stops at 135.00, good anytime.

On Friday, September 8, we advised changing our stops on the Canadian dollar to .7327, close only, basis December.

On Tuesday, September 12, via flash update, we advised buying December gold at the market, then trading at 389.00. Have a great trading day.

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