

FRIEDBERG'S

COMMODITY & CURRENCY COMMENTS

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Gold: why we are so bullish

Almost imperceptibly gold has moved, over the past half-century, from the public to the private realm. This dramatic development carries momentous implications for the future price of bullion. And a lifetime opportunity to earn fabulous returns.

To appreciate the unfolding situation, one must first garner a proper understanding of the present balance of supply and demand for gold. It is a fact that the world consumes far more gold than is being mined and that this basic gap has been widening for years. For example, figures for the first half of 1995 show a production deficit (mine production minus fabrication demand) of 532 tons, an amount equal to 48% of mine production against a deficit of 245 tons, or 21%, in the first half of 1994. (All supply and demand statistics are taken from Consolidated Goldfields). With new mine production now practically stagnant (more on this later), any increases in demand will be reflected in ever-widening production deficits.

Where and why does demand increase? Look first to Asia, because of rapidly rising living standards and because the price of gold has been depreciating in local currency terms for quite some time.

Little tidbits of necessarily imprecise information provide a telling story: Asian gold demand soared 13% in 1995, according to the World Gold Council. Fabrication demand in India has more than doubled in the past 10 years through the use of gold in decorative applications as well as expanding jewelry sales (Gold Fields Mineral Services Ltd.). Domestic gold consumption in China is predicted to exceed 1,000 tons in 1996, up from 800 tons in 1994 and a mere 350 tons in 1993 (National Price Information). Incredibly, 1,000 tons represents 45% of total world mine production. And that is only China.

It is worthwhile noting that the basic balance of supply and demand for gold that we have been using does not take into account bar hoarding/investment demand, simply because this type of demand is not constant and tends to correlate strongly and positively with the trend in the price of bullion (with the exception perhaps of some sectors of the population of France and parts of Southeast Asia, where there exists a genuine portfolio demand for gold). We prefer to base our case on the price-sensitive fabrication sector simply because this allows us to assume a stable price for the next five years, which in turn will demonstrate the absurdity

of precisely such a forecast. We will return to this point after we understand the role of central banks in the gold market.

Having shown a basic production deficit for 1995 — equal to 1,064 tons on an annual basis — we need to ask ourselves how this deficit is covered. Aside from an estimated 564 tons from old gold scrap, the balance comes from central banks. (All numbers are, of course, highly imprecise, but imprecision has its beauty and value, as Impressionist paintings have demonstrated.) Either the private sector buys gold from the official sector, i.e., central banks, or it borrows it from them. While the first phenomenon is well understood, the second one is not, and it is just as crucial, if not more so.

Charts 1 and 2 depict a steady but relentless fall in official gold holdings, in absolute and, more pronouncedly, in relative terms. The decision to demonetize gold dates back to the Genoa convention, in the early '20s. There is no need at this time to discuss the reasons behind this decision. Suffice it to say that it was accompanied by the growing acceptance of paper money that came with relatively moderate rates of inflation in the industrialized world (except for the 1973-81 period) and the development of sophisticated money and capital markets.

Central bank sales in the late '60s (the US Treasury, at \$35/oz.), in the '70s (especially the IMF), and the late '80s and early '90s (Canada, Belgium, and Portugal are some of

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Contributions by Albert D. Friedberg, 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.

the most noteworthy examples) helped to keep bullion prices sufficiently low to stimulate growing private demand.

For a time, new mine production, responding to the temporarily high prices of the late '70s and early '80s, coupled with official sales filled this growing private demand. In more recent years, however, low prices have been responsible for a levelling off of mine production (last year production fell 1%). Particularly affected has been South Africa where production has fallen to the lowest levels since 1958, because of rising costs, stagnant prices, and a deterioration in the quality of ore at older mines.

Once the producer of 75% of the world's output and one of the main unspoken causes behind the US refusal to raise the \$35/oz. price (so as not to benefit the Apartheid government), South Africa will struggle to mine 530 tons this year versus 1,000 tons in its heyday, barely generating positive financial results.

While central bank demonetization is likely to continue for still some time, there is some reason to believe that the process will slow down, if not cease altogether, in the not-too-distant future. In the first place, central bank sales have been affected by only a reduced number of central banks (including the former Soviet Union, where it was mostly a question of need than a shift in portfolio preferences). This is noteworthy in view of the fact that there are a number of central banks with very substantial holdings, such as France and Italy, which have undergone repeated foreign exchange crisis and yet have deemed it unnecessary (or improper) to sell even one ounce of gold.

Perhaps it reflects the basic and innate conservatism of central bankers. Or perhaps their fear that an announcement that they have been selling gold may trigger an undesirable drop in the price, hurting themselves as well as other central banks. Or perhaps it is the fact that paper money reserves have been accumulating at such a rapid pace that it becomes imprudent to part with the only truly international money and war chest governments have ever had. Be that as it may, it is not demonetization *per se* but its pace that is relevant to the market; in this respect, one can take some comfort from the measured restraint they have shown to date, conditioned by tradition, innate conservatism, and a modicum of prudence.

But there is yet another reason why demonetization may no longer be relevant. And that is the growing privatization of the gold market. Chart 3 shows that in the early '50s, official gold holdings represented 100 years of fabrication demand, an absolutely formidable "overhang." By the end of 1995, this overhang had been reduced to 7 years. If we further assume that the US, France, Switzerland, and a small number of other central banks that have recently bought gold (Brazil, Greece, Romania) are not likely to be sellers in the foreseeable future, fabrication demand coverage is reduced to a mere 3.7 years (marked with a dot in Chart 3).

We have borrowed this concept of demand coverage from a similar concept used by the IMF in assessing the adequacy of international reserves in developing countries: months of imports coverage. This measure gives no weight to

the credit side, i.e., exports, even though it is highly unlikely that exports will cease altogether. We too give no weight to the credit side, i.e. mine production, but unlike our paradigm, we have a very valid reason. To wit, thanks to the gold lending activity of central banks, which facilitate the increasingly popular forward sales undertaken by mining companies, a significant portion of future mine production has been pledged for repayment.

In the statistical balance of supply and demand, loan repayments appear as an increase in demand rather than a reduction in supply. Either way, today's gold loans have reduced the future credit side of the ledger. Anecdotal evidence speaks of forward sales equal to 50% to 60% of future production, going out as far as five and six years. If these loans are not renewed — and we shall soon see why they may not be — net repayments will have a profound and dramatic impact on spot supplies of the precious metal.

Let us digress for a moment and explain the mechanics of these gold loans. The operation is remarkably simple: A mine wishing to finance and then hedge future production borrows gold from a central bank (only they have the quantities needed), normally through a large intermediary merchant bank or bullion dealer, and proceeds to sell this gold to raise the required cash. For these loans, central banks charge, under normal circumstances, anywhere between 25 and 50 basis points per annum.

This was the case in the early days, between 1982 and 1987. As the demand for loans rose and the number of central banks willing to tie up gold in lending operations stabilized, leasing rates, as they are called, began to rise (Chart 4), making it increasingly less profitable for mines to engage in this sort of operation. For those more familiar with the world of futures than with the world of bullion financing, it is useful to think of rising lease rates as a narrowing of the deferred premium, otherwise called the contango. Heavy forward selling throughout 1995 depressed the contango; hence, forward selling has become less attractive.

There are three additional points that bear mentioning with regard to gold loans. The first is that central banks are short-term lenders, generally for periods of up to three months. These short-term loans are "converted" into long-term, five-year to six-year loans by bullion dealers, confident that they can roll over the three-month loans at maturity. Understandably, this borrow short/lend long operation generates a potentially devastating mismatch. Should central banks refuse, for whatever reason, to roll over their loans, or, more plausibly, should they demand even higher lease rates, the bullion dealers' positions are negatively impacted. As lease rates rise (as they are presently doing), counter-party risks rise. This, in turn, causes lease rates to incorporate risk premiums, accentuating the backwardation. And, as we have already seen, a widening backwardation reduces the attractiveness of new loans, and brings nearer the reverse flow, i.e., net repayments.

The second point is that there exists little reliable information concerning the amount of gold loans presently *outstanding*. A recent study (*The Derivative Revolution* by Jessica

Cross) estimated that *outstandings*, as at the end of 1994, had dwindled to practically zero.

We believe that these numbers are highly suspect for the following reasons:

(a) Although some deals were highly publicized, most of these transactions are kept confidential so as not to affect the market; therefore there were, in all probability, many more loans taken out than estimated;

(b) Given the satisfactory results obtained by central banks to date and the obvious expansion of the lenders' market, it is puzzling to see a rise in lease rates. Unless, of course, central banks' lending capacity is being strained. Since new deals are not that much larger than earlier ones, one must assume that older loans are still on the books and are being continuously rolled over.

Finally, one could argue that central bank sales and new mine production are the two most reliable and least tentative inputs in the gold equation. At the opposite end are fabrication demand, scrap recovery, and gold loans.

But what if fabrication demand has been far stronger than heretofore imagined, and the bullion market has absorbed far greater amounts of borrowed gold, including outright forward (hedge) sales (mostly executed on the over-the-counter market), bullion dealer sales to delta hedge the granting of puts, etc.? Necessarily, repayments must be greater, and the impact on the spot equation equally greater.

It is thus quite clear that the remarkable price stability of recent years was bought by drawing down from official reserves to the point that practically speaking they are no longer relevant and by borrowing from future production. While this state of affairs can continue for yet some time, the longer it does, the more explosive will be the final resolution. And the reason is relatively simple: over 3 years, and at unchanged prices, a 3% growth in fabrication demand adds about 600 tons to the 1,800 tons projected cumulative production deficit. Over 5 years, 1,500 tons to 3,000 tons.

Further gold loans to cover this "hole" may become too costly, especially if and when lease rates begin to exceed LIBOR rates. The inconvenience to extend forward existing loans will in fact mean that producers will be repaying loans. Repayments, as we have seen, will widen the production deficit by perhaps thousands of tons over three years. Spot supplies will become ever more scarcer.

In due course, fabrication demand will be rationed, and new mines will be opened. This is a lengthy process, however. In the interim, speculative juices begin to flow; investment demand is added to (and takes over from) fabrication demand. Here and there some central banks, feeling nostalgic, join the fray. Billions of dollars of hidden derivatives come into play and shorts scramble to cover. Prices skyrocket.

The very mechanism that has brought such remarkable stability to the market in recent years becomes the destabilizing element. As every head of household knows, persistent borrowing in the face of declining income is a recipe for future bankruptcy. In much the same way, the gold market has been borrowing to cover its production shortfalls. If South Africa's experience is any indication, there is precious little hope for increased production in the future (at these prices). When borrowing is no longer feasible, the Ponzi scheme will have been exposed. Soaring lease rates is the first market symptom that the game may be up.

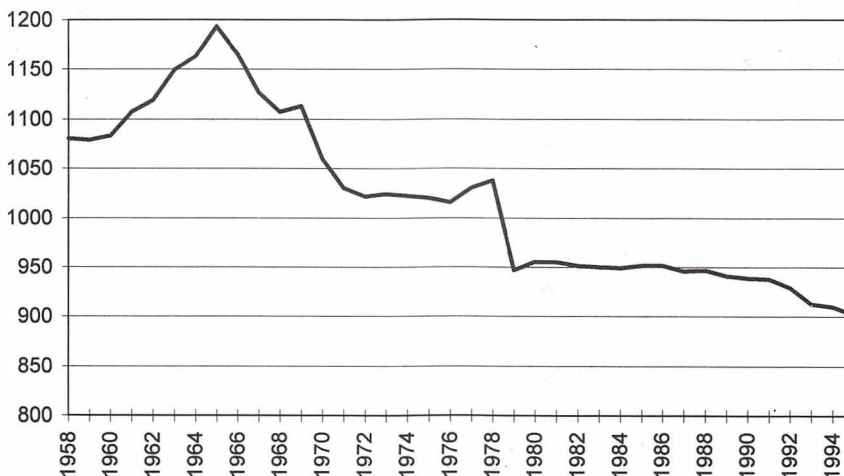
Fortunately for us, not only has the market made a bet that prices are unlikely to move decisively beyond \$400/oz. thanks to the Fed's "skilful" handling of inflation, but the market has made a gigantic bet that prices will remain stable. Implied volatilities have collapsed to the lowest levels in memory. As a result, long-term call options offer, in our opinion, the most significant speculative opportunity in a commodity since the early '70s.

STRATEGY: *We are advising our (patient) clients to buy long-term call options. They are a giveaway.*

Chart 1

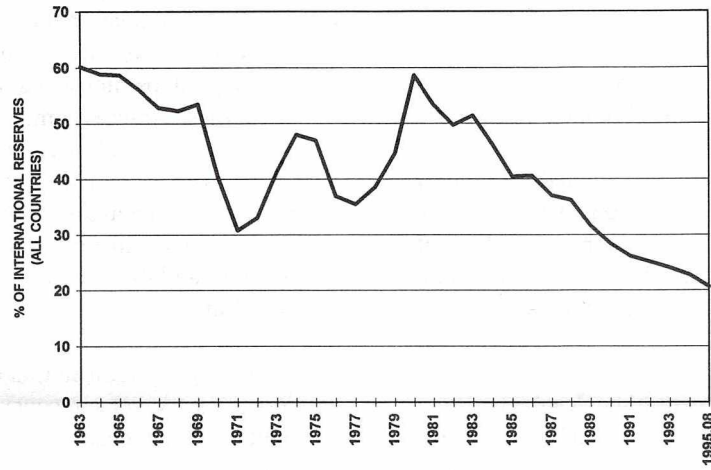
Central Banks Gold Holdings

(Million Fine Troy Ounces)



Source: International Financial Statistics, IMF

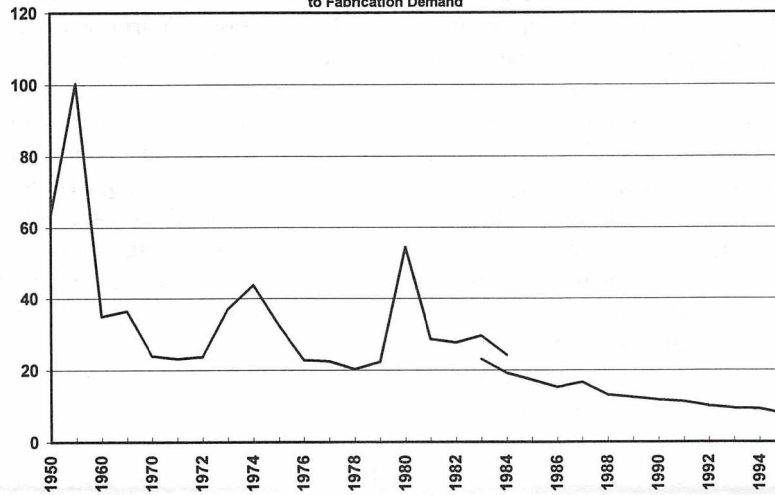
Chart 2
GOLD AT MARKET PRICES /
TOTAL INTERNATIONAL RESERVES



Source: International Financial Statistics, IMF

Chart 3

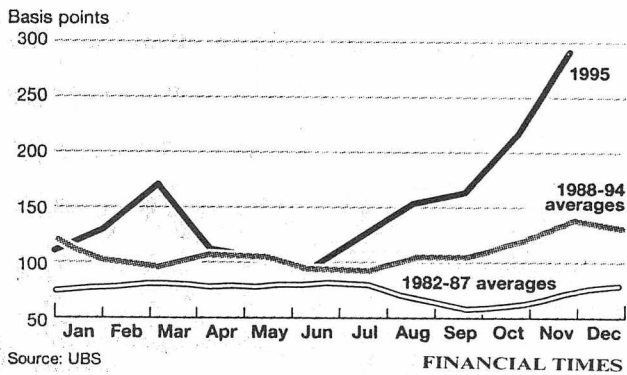
Demand coverage (In Years):
Ratio of Total Central Bank Gold Holdings
to Fabrication Demand



(Graph line after break includes Communist country fabrication demand)
Source: International Financial Statistics, Consolidated Gold fields.

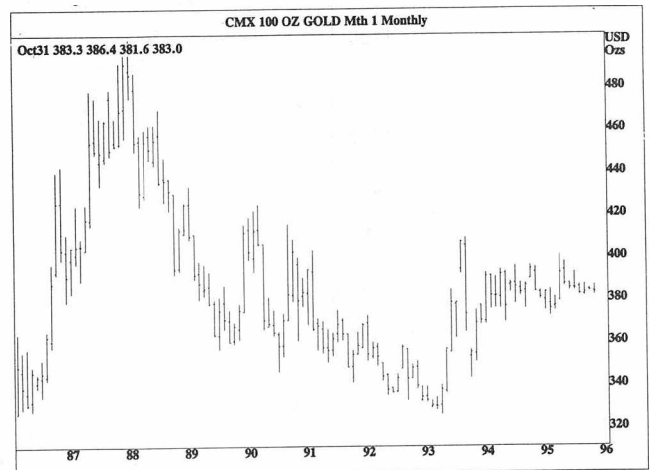
Chart 4

3-month gold lease rates



Source: UBS

Chart 5



FINANCIAL FUTURES

The elixir of easy money

Federal Reserve Vice Chairman Blinder's antennae are twitching, but, he commented on November 16, "it has not gone beyond that." Yet. What set off his electronic equipment is the obvious weakness shown by the economy in recent weeks. Retail sales, consumer credit, new non-defence capital goods orders, and the National Association of Purchasing Index have rolled over sufficiently to suspect that the US economy may have entered a recession.

Even the expectation that export growth would pick up because of stronger foreign growth — a hope that the Fed held out at the September FOMC meeting and that caused it to delay lowering rates — is coming to nought as the major developed economies struggle under the weight of debt, fiscal retrenchment (primarily more taxes), and high rates of unemployment.

Leading economic indicators in Germany, Japan, France, and the UK have all plunged, showing year over year declines. With perhaps the sole exception of the UK, now planning substantial pre-electoral tax cuts, G-7 governments, led by the US, are likely to use *monetary policy* rather aggressively to once more kick-start economic activity.

The irony, of course, is that the slowdown is, among

other reasons, a function of an overindebted consumer, and yet monetary authorities are intent on seducing him with more debt. Progressive elements retort that the wealth effect of rising equity prices more than offsets rising indebtedness. It may, for now. But we should not forget that equity prices can go down as well as up — they have always been instruments of variable return — while debt is fixed. Will they remember to blame the ensuing depression on the poverty effect?

It is useless to bet on a bear market so long as the monetary authorities are trigger-happy, totally unconcerned about the inflationary implications of their actions and unmindful of the long leads that such actions have. But keep an eye on gold and commodity prices (see our continuing bullish comments on grains, cocoa, and now coffee) as they cast their long shadows.

STRATEGY: *At this point, any attempts to short the S&P 500 and T-bonds are initiated with a view to capitalize on quick trading turns; stops are tight and objectives are limited. A genuinely bearish posture will have to await the onset of much higher commodity prices.*

Chart 6

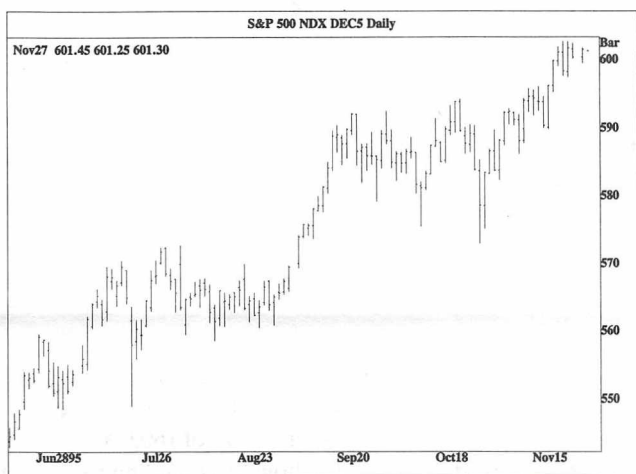
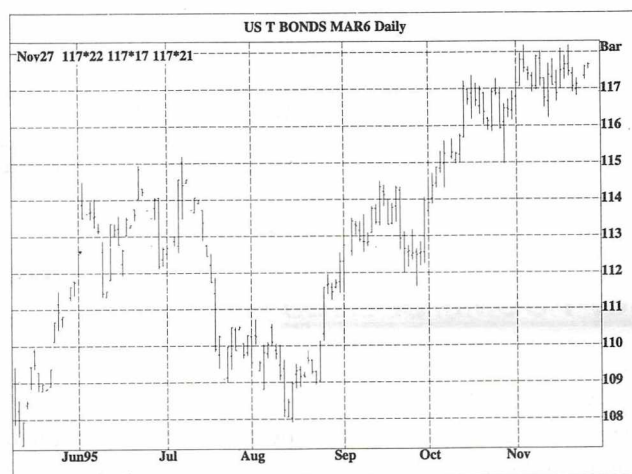


Chart 7

**CANADIAN DOLLAR**

Priced too cheaply, despite Quebec

For months, we have been discussing the "cheapness" of the Canadian dollar, arguing that on purchasing power calculations, the unit was undervalued by between 15% and 20%. The most recent Monetary Report of the Bank of Canada, gave us an opportunity to corroborate this impression — from an entirely different angle.

The Bank provides a chart that shows the profit margin, i.e., profit as a percentage of operating revenues, of two sectors — tradable goods and the "other nonfinancial goods and service." Logically, the tradable goods sectors should be influenced by the prices of internationally-traded goods, by the exchange rate and, to lesser extent, by domestic activity.

For the purposes of our simple exercise, we ignored the prices of internationally traded goods and factored out the domestic activity element by subtracting the profit margin figure of the "other nonfinancial goods and services sector" from the tradable-goods sector profit-margin figure. The result showed a remarkable but expected correlation between relative profitability of the tradable-goods sector and the nominal level of the Canadian dollar. What stands out is that the external sector is relatively more profitable than the domestic sector anytime the exchange rate is equal to 1.17 or higher. Since we are currently trading around 1.35, one could "conclude" from the above exercise that the Canadian dollar is "undervalued" by approximately 15%.

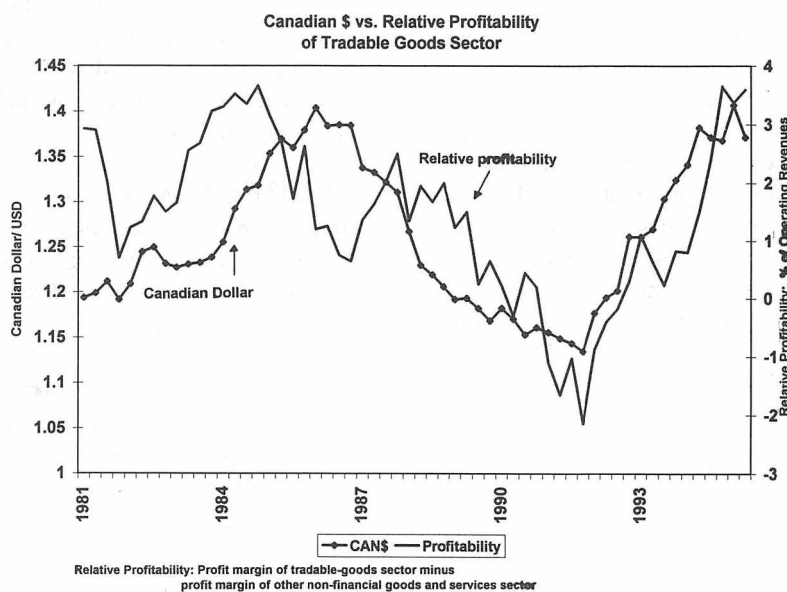
We are reticent to project a currency appreciation of

this magnitude on the basis of undervaluation alone. There are many more factors that come into play, among them the following: capital flows, in turn influenced by political and economic factors; the domestic savings rate; terms of trade; international economic activity; and so on.

Nevertheless, we continue to believe that enough progress has already been made at the fiscal level, particularly at the provincial level, to warrant a constructive investment approach to Canadian dollar investments.

STRATEGY: *The purchase of 5-year forwards, at around 1.43 is highly recommended. Alternatively, buy 5-year Canadas, yielding 160 basis points more than their U.S. counterparts.*

Chart 8



SOFT COMMODITIES

Cocoa

News surrounding the dispute between the Ivory Coast and shipping companies over freight rates has served only to cloud the real issues. Happily, the matter has been resolved, and as cocoa starts arriving at European ports, a true test of the tightness we've seen recently will be applied.

The most current statistics, released by the ICCO, show an 18,000 tonne production/consumption deficit for 1995-96, which is about 30,000 tonnes better than the last series of forecasts. Year-end carryover stocks would be 1.17 million tonnes, which would represent a 45% stocks-to-consumption ratio. Bull markets in cocoa have come with carryover stocks in the mid to low 30% range, but the trend is moving in the right direction, and we take issue with the ICCO's optimistic production view.

The ICCO predicts increased production for every producer except Nigeria. It expects Malaysia to bounce back from a disastrous 10-year production low of 160,000 tonnes to 200,000 tonnes. It is hard to see how this could happen when only part of their output decline was related to a temporary weather problem. Since 1990, 30% of cocoa growing land has been replaced by other crops. In fact, Malaysia has produced less cocoa every year since 1990.

Let's have a little fun with numbers. If Malaysian production were to decline this year by the same rate that it has been declining since 1990, it would have only 130,000 tonnes. All of a sudden the 45% carryover is 41.5%. This sentiment of Malaysian production is mirrored by E.D. & F. Man in its September report: "...Malaysian production is in a long-term decline and that future production will be well below the average level of the last three years" With political turmoil,

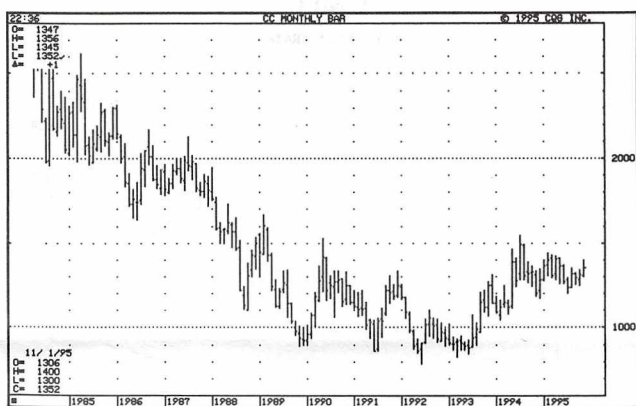
often violent, dotting the landscape of African producers, it's hard to consider production increases to be in the bag.

On the demand side, we've discussed the sluggish grindings in Europe in previous issues, and these have been very much in line with the equally sluggish consumption in the Western Europe and North America. But East is where the future holds promise. While consumption worldwide has been limping along at a 2% growth rate, demand for cocoa in Asian countries is expected to grow by 4.5% per annum over the next 5 years.

In Russia, the five biggest domestic producers of chocolate are said to have increased output by some 10% this year to meet rising demand. What is really exciting about the Russian outlook is foreign investment in the industry. The list of Western companies that have set up shop to produce chocolate in Russia reads like a who's who of the corporate West: Nestle, Kraft Jacobs Suchard, Cadbury Schweppes, and Mars. One would think that these powerhouses have done their homework and think that there's a market for their wares.

STRATEGY: *The market disappointed us and forced us to liquidate long positions in what appears to have been a false breakout of the 15-month high level consolidation. We now require a move above 1400, basis the nearest contract, before we reenter the long side of this exciting market.*

Chart 9 - Cocoa



Coffee

In recent weeks coffee prices have completed their retreat from a powerful bull thrust generated by two debilitating frosts in Brazil last year. Actually, the move started without any help from mother nature as ACPC (Association of Coffee Producing Countries) implemented a highly effective retention scheme that saw prices rally last year from a below-cost-of-production 60¢ a pound to over a dollar. Then came the frosts, and the market more than doubled in price to \$2.70/lb. The market is now on the skids, as traders don't believe that ACPC members can adhere to the self imposed 60-million-bag export quota.

There's been a wide gulf between estimates of the extent of damage to the Brazilian 1995-96 crop. Forecasts for the

crop have ranged anywhere between 12 million and 18 million bags. Most non-Brazilian analysts' estimates come in at about 16 million bags, a far cry from the average crop of the last five years of 27.5 million bags.

Last year the world crop was about 94 million bags; this year's crop has been pegged by some forecasters to be as low as 82.5 million bags. Even with consumption having tapered off in recent years, the market still faces a production/consumption deficit of about 10 million bags.

But more alarming are the ending stocks and stock-to-consumption ratios. At the end of 1995-96 global stocks will have dwindled to about 20 million bags, which represents a stock-to-consumption ratio of about 21%; this in a market that is accustomed to seeing that ratio at about 35%. Back in the 1986-87 season when there was a disastrous 80-million-bag crop, global stockpiles were so healthy that the market left the year with a 35% of consumption carryover.

Although statistics show that coffee consumption in North America is on the decline, the numbers may be a bit dated. There has been a proliferation of coffee shop chains throughout Canada and the United States. Sales at one chain, Starbucks, which has 675 shops in the US and is opening new ones at the rate of 250 a year, have exploded by 156% in their past fiscal year. Bookstore chains are leasing space to coffee shop franchises so patrons can sip while they browse.

We find the market's focus on the collapse of faith in the retention scheme to be shortsighted. The facts state clearly that there is simply not enough coffee in the world. Any weather accident or uptick in demand could send this market flying.

STRATEGY: *This thoroughly sold-out and demoralized market is providing an intriguing entry point. Remain long March '96 coffee with stops at 106, close only.*

Chart 10



Soy complex

Typically by this time of year, traders have long forgotten the spring/summer weather-watch that causes US grain markets to sway to and fro each year. The excitement and volatility

that would result from each dry spell or rainfall has become a distant memory. The trees have shed the last of their leaves, most of North America has had a snowfall or two, and the last US crop to be harvested, soybeans, will already have had a healthy thumping of hedge selling.

This year, however, is different. Prices of soybeans and soymeal are steadfast in maintaining levels that are 20% and 15% higher, respectively, than the average prices of the last six (post 1988-89 bull market) years.

As with the other grains, each monthly USDA crop report brought news of downward revisions of global production figures. The November data showed a US soybean crop of 60.6 million tonnes versus last year's 69.9 million tonnes, a drop of 13%.

Among South American producers, Argentina's crop will be slightly higher, but any gains scored by Argentina will be quickly erased by Brazil. Brazilian output will fall by 10.7% to 22.75 million tonnes.

Across the ocean, the world's only other meaningful producer of soybeans, China, will see its production decline as well. The USDA pegs the Chinese crop at 15 million tonnes, down from last year's 16 million. But Bill Gary, a well-known industry hawk who writes an excellent newsletter called *Price Perceptions*, sees the Chinese yielding no more than 14 million tonnes, a decline of 12.5%. (*Price Perceptions*, CIS, Inc., Suite 2970, Oklahoma City, OK 73102, 405-235-5687.) The Chinese issue is especially important as it sees its role in

yet another commodity market shifting from self-reliant/exporter to importer.

As the US is the largest producer, all eyes should be focused not only on its crops but on its export figures and what will remain in silos to tide demand over until Brazil and Argentina harvest their beans in the spring. The USDA predicts that US exports will fall to 22.2 million tonnes in 1995-96 from 23.4 million tonnes last year. Most analysts disagree, as the USDA's own export commitment data show that the tally for beans already shipped is running over 8% higher than the same time last year. Even a modest increase in exports for the whole season to 23.6 million tonnes, a number used by some forecasters, would knock the socks off ending stocks. The 10-year average of the stocks-to-consumption ratio is 14%. The figures we're using would leave the US with 4.72 million tonnes, for a stocks-to-consumption ratio of only 7.2%, or 26.3 days of supply versus 51.1 days at the end of last year.

The price of soybean meal continues to outperform the beans (See Chart 11), as Asians are increasing their use of the protein-rich feed. The microscopic global carryover stocks of meal the market has become accustomed to should make the drama accompanying the coming shortages most riveting in this section of the complex.

STRATEGY: *The bull market is in full swing. If you really want to ride this winner, allow for ample stops; bring them up only to 201, basis March '96 soymeal, close only.*

Chart 11

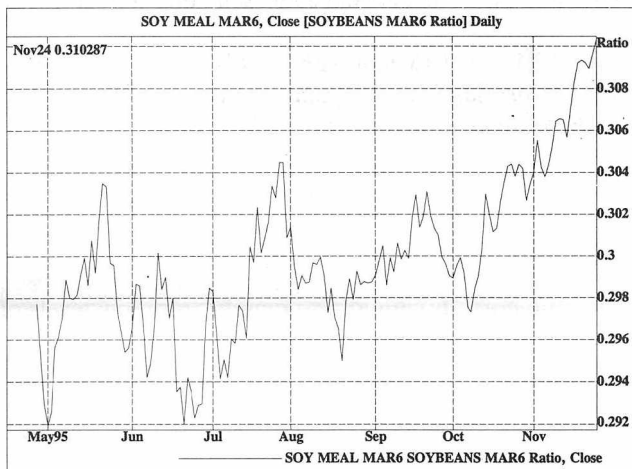
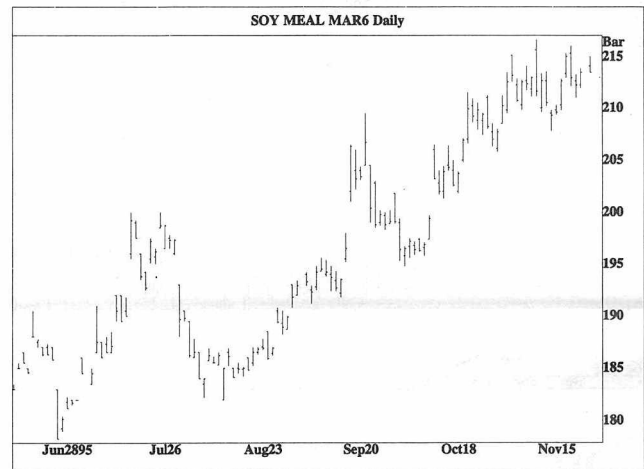


Chart 12



Wheat

World ending stocks of wheat are expected to dwindle to 98.5 million tonnes by the end of the 1995-96 season. Back in June the USDA was saying that there would be 112 million tonnes left, and even then, when compared with the average of the last 5 years' carryover of 136 million tonnes, it was obvious that the world food supply was in trouble. Where has all the wheat gone?

Of all the major exporters only one country, Australia, will have a significantly better crop (17 million tonnes) than last year (9 million tonnes). Even Australia's bountiful crop will provide no evidence that it is bucking the trend of

declining world output, since all it's really accomplished is a return to the level of its 1993-94 crop. Last year's crop was devastated by droughts.

China, the European Union, and Canada will have crops slightly higher than last year, while Argentina's crop will be about 23% lower than last year at 8.5 million tonnes. Although Argentina's crop is dwarfed in size by the other exporters, it is of strategic importance, as it was expected to export as much as 6.2 million tonnes of it. Now that Argentina has suffered through a drought, it will be able to export only 4.3 million tonnes, leaving the other half of the crop for domestic consumption.

As far as demand is concerned, an examination of exports from the world's largest exporter, the US, shows an amazing appetite for wheat. The amazing part is that buyers are not backing away from \$5.00/bushel prices. Since the marketing year began, the US has shipped 15.57 million tonnes of wheat abroad, which is 17.7% above shipments at the same time last year.

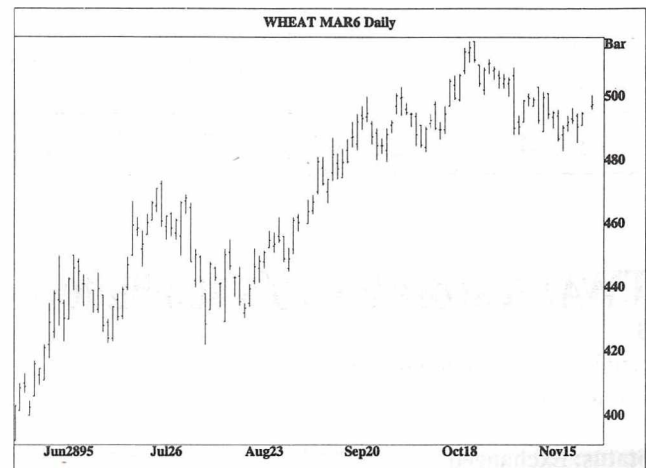
Wheat sold, but not yet shipped, adds an additional 6.3 million tonnes, bringing the total to 21.87 million tonnes sold, which represents over two thirds of wheat exported all of last year.

The high level consolidation of this market has not allowed frugal buyers to find any bargains, and if they want to eat, they'll have to pay the price. In addition the open interest has fallen sharply, indicating a shakeout of speculators with a fear of heights. The market remains in strong hands.

STRATEGY: March '96 wheat has found excellent support above 4.80/bu.; thus, raise stop to 4.79, close only.

— Sholom Sanik

Chart 13



FRIEDBERG CAPITAL MARKETS

Seabil and Tasman vote to merge

Security: 9% convertible capital note

Maturity date: June 27, 1999

Outstanding: \$91.5 million

Recent price: 90¢ per dollar

Expected yield to maturity: 12.53%

On November 20, 1995, shareholders and noteholders of Seabil (NZ) Ltd. and Tasman Properties Ltd. voted overwhelmingly to merge the two companies, creating a new property company to be named Trans Tasman Properties (TTP), with \$1.1 billion in assets and with exposure to both New Zealand and Australia. The proposed resolutions went virtually unopposed with the vote in favor approaching 90%.

The key feature of the agreement has Seabil investors exposed to a higher degree of financial leverage in return for a greater opportunity to participate in capital growth. You will recall that the notes are convertible at maturity. If the noteholder elects to receive stock, each note is exchangeable for one share. If the noteholder elects to receive cash, each note is exchangeable for face value (\$1.00); however, the company may override this election and convert the notes to common stock with a market value of \$1.00. For the Convertible Capital Note (CCN) holders, the opportunity to participate in capital appreciation will arise when the notes mature.

The post merger debt-to-equity ratio is projected to be 1.13, representing a substantial increase over Seabil's pre merger ratio of .69. This leaves Trans Tasman with less room to maneuver financially in the event of a downturn. The company, however, will generate enough cash to meet all its obligations, including its minimum debt amortization. The reduction in debt levels combined with an anticipated decline in interest rates in New Zealand should lower the future interest expense of TTP and reduce the perceived risk of the company over time. As well, both interest and asset coverage

ratios have improved, post merger. Therefore, the notes maintain their attractiveness with enhanced security of cash flows.

The outlook for the New Zealand commercial real estate market is very optimistic. Consensus puts the expected growth rate of rental increases conservatively at 7% (per annum compounded for 5 years) for prime CBD rentals in Wellington and 5% (per annum compounded for 5 years) for average quality space. As Tasman properties are significantly less over-rented, and 73% of the entire portfolio has New Zealand exposure, we believe that opportunity exists for participation in capital appreciation. Although economic fundamentals in Australia are generally unfavorable, independent industry experts are forecasting moderate rental growth in the CBD office property market. Given that Australian properties were originally part of Tasman, this portion of the portfolio could also benefit from low levels of over-renting.

Industry analysts have estimated that the Net Tangible Asset Value (NTAV) of Trans Tasman will range from \$1.34 to \$1.66 when the notes mature. The most conservative of projections suggest an NTAV of approximately \$1.30. Even with the stock trading at a 20% discount to NTAV, CCN holders could likely participate in capital appreciation, thus realizing a higher yield (see Chart 14). Given that 99% of Seabil shareholders voted in favor of the merger, one might conclude that they feel the amalgamation enhances their investment and bodes well for CCN holders looking for higher yields.

STRATEGY: We believe that the 9% convertible notes present an opportunity for a risk-tolerant investor to capitalize on Trans Tasman's growth opportunities. The interest and asset coverage provide improved security to the notes' cash flows, while the convertibility feature provides for participation in equity appreciation.

Chart 14 – Price and yield

Stock Price	100.00	105.00	110.00	115.00	120.00	125.00	130.00
YTM	12.53%	13.73%	14.88%	16.00%	17.08%	18.12%	19.13%

TWA: A score for 10% bondholders

S
Security: Senior secured bonds
Coupon: 10%
Maturity: November 3, 1998
Status: Exchanged

Good news for TWA 10% bondholders. Our strategy to liquidate the entire restructuring package except for the new 12% bonds has been successfully implemented (see Chart 15). Only the Contingent Payment Rights and an Equity Value Fill-Up remaining, as they have not reached their critical valuation dates.

The value of these items have been conservatively estimated for the purpose of this illustration and will be known with certainty by year-end. The total package value of \$918.97 is above our previously estimated range, primarily because of a hefty windfall realized on the oversubscription privilege for TWA Equity Rights. To date, the amount of cash generated per \$1,000 face value of TWA 10% is \$257.56, which includes the liquidation of common stock received in lieu of interest on the new 12% bonds.

A review of third-quarter results showed increased profitability (before non-recurring items), primarily because of successful cost-cutting measures, while maintaining competitive yields and load factors. The results also showed a significant improvement in short-term liquidity and coverage ratios; however, the company remains highly levered and sensitive to changes in the favorable business climate.

The new 12% bond represents over 70% of the package value and is currently trading at \$90 (up from \$87 in September) with a YTM of 18.5%. Comparatively, industry YTM's range from 7% to 9%, and more specifically, the unsecured

debt of a US carrier with a similar story is currently yielding 13.5%. Given that the TWA bonds are fully secured, we should see further increases in their price.

STRATEGY: We feel the spread between the new TWA 12% and similar airline debt does not accurately reflect the level of risk associated with these bonds and continue to look for a more favorable risk assessment from market participants. Therefore, our recommendation is to hold on to the bonds, which offer an attractive current yield at 13.5%, and continue to monitor for further signs of sustainability.

– Peter O’Sullivan

Chart 15

TRANS WORLD AIRWAYS			
Value per \$1000 Face of TWA 10%			
@ November 21, 1995			
	Cash		
	Realized	Estimated	Total
	on Sale	Future	Package
	Thus Far	Value	Value
New 12% Bonds (Note 1)	0.00	671.71	671.71
Contingent Payment Right 1	0.00	29.68	29.68
New Common Equity	78.87	0.00	78.87
Common Equity from Equity Rights	87.49	0.00	87.49
Equity Right Fill-Up (Warrants)	0.00	0.00	0.00
Equity Value Fill-Up (Common Equity)	0.00	24.73	24.73
Contingent Payment 2	0.00	0.00	0.00
	166.36	726.11	892.47
Common Equity from Oversubscription	26.50	0.00	26.50
Total Package Value	192.86	726.11	918.97
Common Equity (Interest Payment #1)	64.70	0.00	0.00
CASH TO ACCOUNTS	257.56		
Note 1 - The Value of the 12% Bond is based on current trading levels.			

Chart 17 – Recommended current portfolio allocations

1. New Zealand (8%) '98 Gov't	20%	4. World Bk (7¼%) '99 DM	25%
2. Fletcher NZ\$	20%	5. Argentina PRE-1 (in pesos)	25%
3. Tranz Rail NZ\$	5%	6. Argentina BOCON (in dollars)	5%

Chart 18 – FOREIGN CURRENCY BONDS

DATE: November 22, 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	99.70	100.55	4.23		May-07
World Bank 5 7/8% 4/02/97 RRSP eligible	101.60	-	-		Feb-04
World Bank 7 1/4% 13/10/99 RRSP eligible	107.60	108.45	4.80		Oct-13
World Bank 9% 13/11/00 RRSP eligible	116.10	-	-		Nov-13
Kingdom of Denmark 6 1/8% 15/04/98	103.15	104.00	4.31		Apr-15
Argentina 8% 5/10/98	100.25	-	-		Oct-05
Bk. Foreign Eco. Affairs 7% 29/3/96	98.15	99.00	9.60		Mar-29
Kgdm. of Spain (6 Mo. LIBOR-1/16) 29/6/02 (semi)	99.30	99.60	-	4.5625	Dec-29
ITALIAN LIRA DENOMINATED BONDS					
Nordic Inves. Bk 12 3/8% 19/04/96	99.25	100.10	11.27		Apr-19
SWISS FRANC DENOMINATED BONDS					
General Electric 4 3/4% 2/7/98	103.15	-	-		Jul-02
General Electric 4 1/2% 17/12/99	105.95	106.80	2.70		17-Dec-96
DANISH KRONE DENOMINATED BONDS					
Kgdm. of Denmark 9% 15/11/96	102.85	103.70	4.98		Nov-15
ECU DENOMINATED BONDS					
United Kingdom 9 1/8% 21/02/01	109.30	110.15	6.75		Feb-21
BRITISH POUND DENOMINATED BONDS					
Kgdm. of Sweden 8 3/4% 29/5/96	100.30	-	-		May-29
FRENCH FRANC DENOMINATED BONDS					
Credit Lyonnaise 9 1/2% 23/12/96	102.90	103.75	5.78		Dec-23
JAPANESE YEN DENOMINATED BONDS					
World Bank 5 3/4% 7/8/96 RRSP	102.90	103.75	0.31		Aug-07
CANADIAN DOLLAR DENOMINATED BONDS					
Ontario Hydro 10 7/8% 8/01/96 (semi) RRSP eligible	100.15	101.40	-1.60		Jan-08
Eksporthfinans 7 3/4% 5/11/97	101.50	102.75	6.19		Nov-05
Royal Bank of Canada 9 1/8% 7/1/97 RRSP eligible	102.40	103.65	5.62		Jan-07
Ontario Province 10 5/8% 15/7/98 RRSP eligible	108.35	-	-		Jul-15
SOUTH AFRICAN RAND DENOMINATED BONDS					
ESCOM 12% 1/5/96 (semi)	98.85	-	-		May-01
AUSTRALIAN DOLLAR DENOMINATED BONDS					
Commonwealth Bk. of Australia 9 3/4% 15/5/96	100.75	101.60	5.92		May-15
NEW ZEALAND DOLLAR DENOMINATED BONDS					
World Bank 12.5% 25/7/97 (semi) RRSP eligible	107.55	108.40	7.06		Jan-25
New Zealand Gov't 10% 15/7/97 (semi)	103.55	104.40	7.10		Jan-15
New Zealand Gov't 8% 15/7/98 (semi)	101.35	102.20	7.07		Jan-15
Fletcher Challenge 10.75% 15/12/97 (semi)	103.75	104.60	8.27		Dec-15
Fletcher Challenge 10.15% 30/11/98 (semi)	103.65	-	-		Nov-30
Tranz Rail Ltd. 10% 15/10/99 (semi)	104.00	104.85	8.50		Apr-15
DB Group 7% 30/6/96 (semi) matures @ 85	86.00	86.85	9.73		Dec-30
Seabil Ltd. 9% 27/6/99 (semi)	90.40	91.25	12.41		Dec-27
ARGENTINEAN PESO DENOMINATED BONDS					
Bocon Pre 1: 1/4/2001	PAR VALUE 131.8381	73.00	IRR 75.00	23.73	4th day 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	12.34		Nov-15
Atari Corp. 5 1/4% 29/4/02 CV@16.31 p/sh	46	47.5	20.72		Apr-29
Coeur D'Alene 6% 10/6/02 CV@26.00 p/sh	86.5	88	8.45		Jun-10
Glycomed 7 1/2% 1/1/03 CV@14.06 (semi)	77.25	78.75	12.03		Jan-01
California Microwave 5 1/4% 15/12/03 CV@28.44 p/sh (semi)	96.25	97.75	5.60		Dec-15
U.S. DOLLAR DENOMINATED FIXED RATE BONDS					
World Bank 7 1/8% 27/9/99 (semi) RRSP eligible	104.30	105.15	5.58		Mar-27
Farm Credit Corp 7 3/4% 10/06/96 RRSP eligible	100.40	-	-		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)	83.85	84.85	-	8.0865	Mar-25
United Kgdm. 30/9/96 3 mo.LIBID-1/8 (qtlly),callable @100	99.81	100.11	-	5.625	Dec-29
Bocon 1/4/01 (30 day LIBOR) starts paying May 1,97	PAR: 122.2982 86.25	87.10	18.18		May-01-97
Argentina: Series L:FRB 31/3/05, 6 mo. LIBOR+13/16 (semi)	63	64.5	16.47	6.8125	Mar-29

GOLD (in ounces, at market prices, can also be held in your bond account)

client eligibility determined at point of sale.

HOTLINE UPDATE

Monday, October 23, 1995:

Good morning for Monday, October 23, 9:45 am. This is a flash update. Buy December Canadian dollar at the market, presently trading at .7300.

Tuesday, October 24, 1995:

Good afternoon for Tuesday, October 24. We have two new recommendations: Raise stops on long December T-bonds to 116.00, good anytime, and lower stops on short December crude oil to 17.70, close only.

Wednesday, October 25, 1995:

Good morning for Wednesday, October 25, 8:30 am. This is a flash update. Liquidate long December Japanese yen positions at the market, currently trading at 99.75, cancelling the stop of 99.46, close only.

Wednesday, October 25, 1995:

Good morning for Wednesday, October 25, 9:25 am. This is a flash update. Sell short December Japanese yen positions at the market, currently trading at 99.25.

Wednesday, October 25, 1995:

Good afternoon for Wednesday, October 25, 3:20 pm. This is flash update. Liquidate long December S&P contracts at the market, currently trading at 585.20, cancelling previous stops of 581.00, good anytime.

The following is a recap of yesterday and today's flash updates. At 8:30 am today, we recommended to liquidate long December yen positions trading at 99.75. At 9:25 am, we recommended to sell short December Japanese yen contracts trading then at 99.75.

Last night we recommended to raise the stop on long December T-bond positions to 116.00, good anytime and to lower stops on short December crude oil positions to 17.70, close only.

Thursday, October 26, 1995:

Good afternoon for Thursday, October 26, 3:25 pm. This is a flash update. Reinstate long S&P. Buy December S&P 500 at the market, presently trading at 578.00.

Friday, October 27, 1995:

Good morning for Friday, October 27, 10:40 am. This is a flash update. Liquidate long December S&P positions at the market, presently trading at 576.40.

Friday, October 27, 1995:

Good afternoon for Friday, October 27. We have one new recommendation: Place stops on short December Japanese yen positions at 100.30, good anytime.

The following is a recap of this week's recommendations: On Monday, October 23, via flash update, we recommended the purchase of December Canadian dollar, at the market, then trading at .7300.

On Tuesday, October 29, we recommended to raise stops on long December T-bonds to 116.00, good anytime and to lower stops on December crude oil to 17.70, close only.

On Wednesday, via flash update, we recommended to liquidate long December yen positions at the market, then trading at 99.75. Later in the day, we recommended to go short the December Japanese yen at the market, then trading at 99.25. Finally, we also recommended to liquidate long December S&P at the market, then trading at 585.20.

On Thursday, via flash update, we recommended to reinstate long December S&P at the market, then trading at 578.00.

On Friday, via flash update, we recommended to liquidate long December S&P positions at the market, then trading at 576.40.

Tuesday, October 31, 1995:

Good afternoon for Tuesday, October 31. We have one new recommendation. Place stops on long December Canadian dollar at .7325, good anytime.

Thursday, November 2, 1995:

Good morning for Thursday, November 2, 10:40 am. This is a flash update. Buy December cotton at the market, currently trading at 85.10, placing initial stops at 80.50, good anytime.

Friday, November 3, 1995:

Good afternoon for Friday, November 3. There are no changes or new recommendations. The following is a recap of this week's recommendations: On Tuesday, we recommended to place stops on long December Canadian dollar at .7325, good anytime.

On Thursday, via flash update, we recommended to buy December cotton at the market, then trading at 85.10, placing initial stops at 80.50, good anytime.

Tuesday, November 7, 1995:

Good afternoon for Tuesday, November 7. There are no changes or new recommendations.

Wednesday, November 8, 1995:

Good morning for Wednesday, November 8, 8:40 am. This is a flash update. Cover short Japanese yen positions at the market, presently trading at 98.55, cancelling the 100.30 stop.

Wednesday, November 8, 1995:

Good morning for Wednesday, November 8, 11:30 am. This is a flash update. Liquidate long December cotton positions at the market, presently trading at 85.50, cancelling the 80.50 stop. We repeat the flash update of 8:40 am this morning to cover short Japanese yen positions at the market, then trading at 98.55, cancelling the 100.30 stop.

Friday, November 10, 1995:

Good afternoon for Friday, November 10. There are no changes or new recommendations. The following is a recap of this week's recommendations. On Wednesday, November 8, via flash update, we advised to cover short Japanese yen positions at the market, then trading at 98.55, cancelling the 100.30 stop. and to liquidate long December cotton positions at the market, then trading at 85.50, cancelling the 80.50 stop.

Monday, November 13, 1995:

Good afternoon for Monday, November 13, 1:40 pm. This is a flash update. Liquidate March cocoa at the market, presently trading at 13.62.

Tuesday, November 14, 1995:

Good afternoon for Tuesday, November 14. There are no changes or new recommendations.

Friday, November 17, 1995:

Good afternoon for Friday, November 17. There are no changes or new recommendations. The following is a recap of this week's recommendations: On Monday, November 13, via flash update, we advised to liquidate long March cocoa at the market, then trading at 13.62.

Monday, November 20, 1995:

Good afternoon for Monday, November 20, 5:25 pm. This is a flash update. We have two new recommendations: Sell December S&P at the market, risking 602.90, good anytime, and sell March T-bonds at the market, risking 118.12, close only.

Wednesday, November 22, 1995:

Good afternoon for Wednesday, November 22, 5:00 pm. This is a flash update. Buy March coffee at the market, risking 106.00, close only.

Friday, November 24, 1995:

Good afternoon for Friday, November 24. This is a complete summary since our last market letter dated October 22, of all liquidations of open positions and new recommendations that remain outstanding.

On Monday, October 23, via flash update, we recommended to buy December Canadian dollar at the market, then trading at .7300.

On Wednesday, October 25, via flash update, we recommended to liquidate long December Japanese yen at the market, then trading at 99.75, cancelling the stop of 99.46, close only. Also on Wednesday, we advised to liquidate long December S&P contracts at the market, then trading at 585.20, cancelling previous stops of 581.00, good anytime.

On Tuesday, October 31, we advised to place stops on long December Canadian dollar at .7325, good anytime.

On Monday, November 13, we recommended to liquidate long March cocoa at the market, then trading at 13.62.

On Monday, November 20, via flash update, we advised to sell December S&P at the market, risking 602.90, good anytime and to sell March T-bonds at the market, then trading at 117.24, risking 118.12, close only.

On Wednesday, November 22, via flash update, we advised to buy March coffee at the market, risking 106.00, close only.

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