FRIEDBERG'S
COMMODITY & CURRENCY COMMENTS

Friedberg Commodity Management Inc. Volume 17, No. 3 March 31, 1996

Waning stimulus

Despite strenuous monetary efforts, a sort of economic *rigor mortis* has set in over OECD economies. No graph can be more descriptive of this alarming but absolutely predictable phenomenon than Chart 1.

The leading characteristic of the yield curve was extensively discussed in academic circles in the '80s and became well accepted in private and public sectors alike. As depicted in the graph, this relationship worked rather well through the '80s and early '90s: Positive yield curves reflected easing monetary conditions, a precursor to economic recovery. Conversely, a flat or negative yield curve signified tightening monetary conditions and the expectation of a contraction in economic activity.

This relationship began to break down in early 1995. A positive yield curve — high by historical standards — has had no discernable impact on the real economy of the OECD countries. Measured on a year-to-year basis, industrial production has continued to decelerate and is now nearing recessionary levels.

Other indicators, too, are telling us that debt creation is no longer having the stimulative effect desired by the monetary authorities. Chart 2A, which admittedly may have been inflated by the increased convenient use of credit cards, speaks of a heavily indebted consumer. Yet, despite this headlong plunge into debt, real non-auto sales have actually fallen in the past couple of months, and on a nominal basis are running at half the pace of the average for the 6 months ending February.

Worrisomely, an unprecedented 60% of consumer spending gains have been financed by borrowing (see Chart 2B). Because debt sooner or later must be repaid, financial strains have already begun to appear at the household level. Bank credit card delinquency rates rose to 3.34% in December, the highest since the eve of the 1990-91 recession. Personal bankruptcies are up a dramatic 22% year over year.

Debt, once a stimulus, now is becoming a burden. Though debt growth is relatively low, nominal GDP growth is even lower (see Chart 3).

For debt growth to have a positive effect on the economy, it must accelerate in much the same way as a drug addict must consume ever larger dosages of the drug. This means that the world monetary authorities will have to step on their monetary accelerator if they wish to re-stimulate economic activity.

In Japan this is already happening. With the Bank of Japan's foot on the accelerator, M1 has skyrocketed and is now 16% higher than a year ago. A similar situation has obtained in Germany, where M1 has accelerated to a 9.7% year-over-year pace.

In the US, on the other hand, monetary policy has remained slightly less accommodative as suggested by the tepid expansion of the adjusted monetary base (2.1% year over year) and the slight contraction in M1 (-2.3% year over year).

Therefore, given the perceived need to reaccelerate debt growth and "stimulate" economic activity, it is nearly certain that in coming months the Fed will engage in a new round of interest rate reductions. This process would continue until clear signs of inflation emerge — at which point monetary tightening would put an end to the increase/acceleration of debt creation and would throw the economy into reverse.

In sum, monetary stimulation works through the economy by creating debt. In the early stages of the business cycle, new debt augments economic activity. Over time, as debt grows faster than income, balance sheets begin to deteriorate, and economic activity grinds to a halt.

To maintain the upward momentum, the debt burden must be alleviated. This can happen only in the context of looser terms and lower *real* interest rates. But because monetary authorities are unable to affect *real* interest rates (except in the shortest of term), debt accretion must inevitably come to an end. What follows is a process called debt liquidation, which accompanied the recessions of 1974 and 1980-82.

Chart 1, depicting the breakdown between a positive

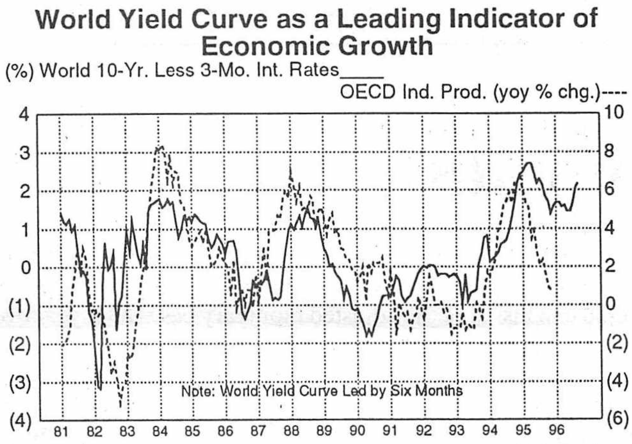
In this issue

Contributions by Albert D. Friedberg, Sholom Sanik and Peter O'Sullivan.

yield curve and positive growth and with which we began our discussion, may be signalling the inflection point: a monetary policy made ineffectual by an over-indebted economy.

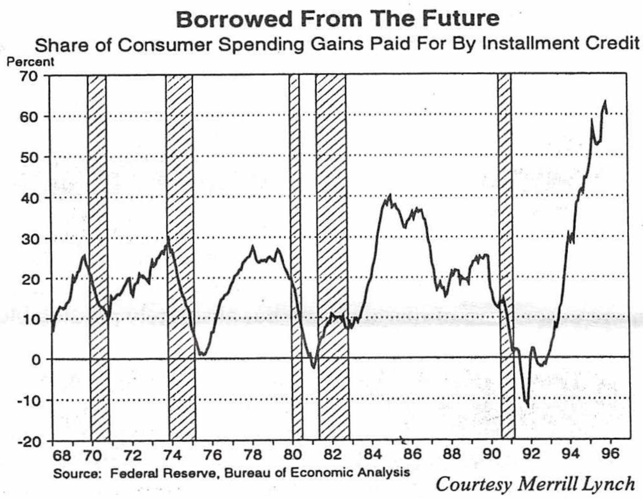
As mentioned earlier, only one of the three major OECD economies has still some room left to maneuver. As the Fed moves into action, we should become evermore aware of the certainty of debt liquidation: Through inflation, as it erodes the burden of debt, or...through a depression.

Chart 1



Courtesy Merrill Lynch

Chart 2B



Courtesy Merrill Lynch

Chart 2A

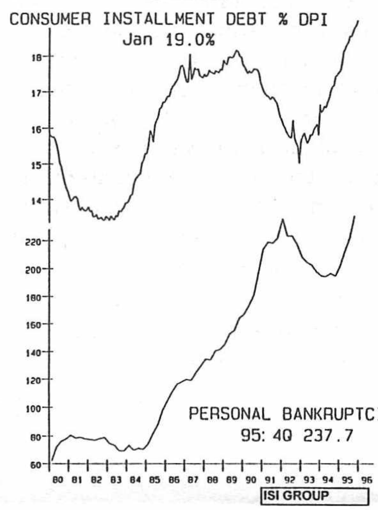
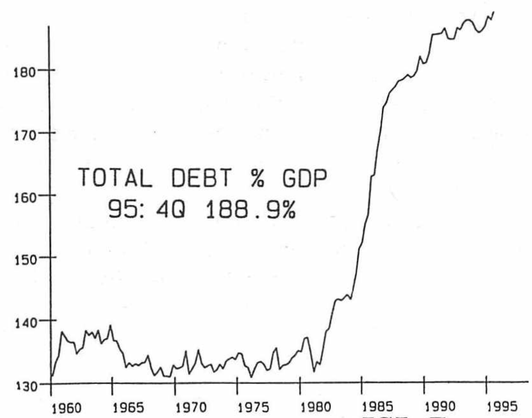


Chart 3



ISI Group

STOCK INDEXES

Still going...

As we head into first-quarter results, it is becoming increasingly clear that the upward momentum in earnings growth is faltering. With most of the gains of streamlining and restructuring behind, companies are beginning to face increasing labor and commodity costs.

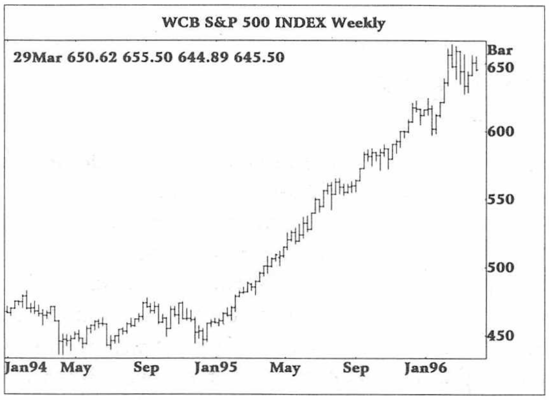
Stephen Roach, Chief Economist for Morgan Stanley, now reckons that labor costs will rise in 1996 to 3% from the originally estimated 2.5%. At the same time, the margin compression resulting from rising labor costs will be accentuated by rising commodity prices, and in particular energy and metals. Nevertheless, the stock market will probably not react to this dramatic compression in profit margins. For one thing, it has been well publicized and, one assumes, discounted. For another, money continues to pour into the stock market via mutual funds and mega-mergers, an unlikely scenario for a bear market.

In the face of deteriorating fundamentals, as we said last month, the market can maintain its upward course only if monetary conditions remain extremely accommodative. And as we said in our introductory piece, this is still a reasonable expectation.

We are fully aware that the bull market is very old. Nevertheless, one of our trusted proprietary sentiment indicators is signalling an important advance, and it is primarily on this basis that we recommended a long *trading* position.

STRATEGY: *Remain long as per our flash update of March 4, with stops at 640.00, good anytime.*

Chart 4



INTEREST RATE FUTURES

Stay long

In line with our opening comments, there's a reasonable chance that the Fed will engage in a new round of interest rate cuts.

STRATEGY: *Hold long T-bond positions as per Flash Update of March 12, leaving stops at 110.00, basis June '96, good anytime. Our preferred vehicle is the Argentinean FRB futures, now trading on the CME.*

GOLD

Patience

We have drawn little consolation from gold's recent behavior. Not only has price action been poor but also bullish sentiment remains too high, speculative long positions too heavy, and the overall open commitment too stubborn in the face of repeated shakeout attempts. The only plus in the picture appears to be the market's ability to absorb just over 200 tonnes of Belgian gold and at least one forward hedge operation amounting to approximately 24 tonnes (Lihir Gold Limited).

Especially distressing is gold's inability to rally in the face of a strong commodity market, marked by a multi-year high in the CRB index (see Chart 5). Only in recent days has the contango begun to narrow again (see Chart 6), a phenomenon that readers will recall preceded the breakout of the $400/oz. barrier in early January.

It is sad and painful to admit it, but the market is not moving our way, at least in the short term. Our case, annunciated with great detail late last year ("Why we are so bullish," November 26, 1995) remains intact. The timing of the move, however, has been postponed.

If we had to guess as to the reasons for this derailment, we would bet that the market is suffering from "more of the same." By this, we mean a continuous stream of forward selling perhaps more fluidly accommodated by new lenders (witness the renewed widening of the contango) and new outright central bank selling. (The case of Belgium, noted earlier, is perhaps only one example, although by itself it is substantial in that it represents better than 6% of world annual consumption.)

As explained in our November article, this process cannot go *ad infinitum:* Sooner or later, all willing central bank sellers will have cashed out (as it is, total central bank holdings in relation to world consumption are no longer imposing). And all future gold production will have been sold in the spot market, opening an enormous future supply gap.

Patience is the watchword.

STRATEGY: *We advised reinstating long futures positions via the Hotline, then trading at $401.30, basis June '96. Place stops at 395, good anytime.*

Chart 5

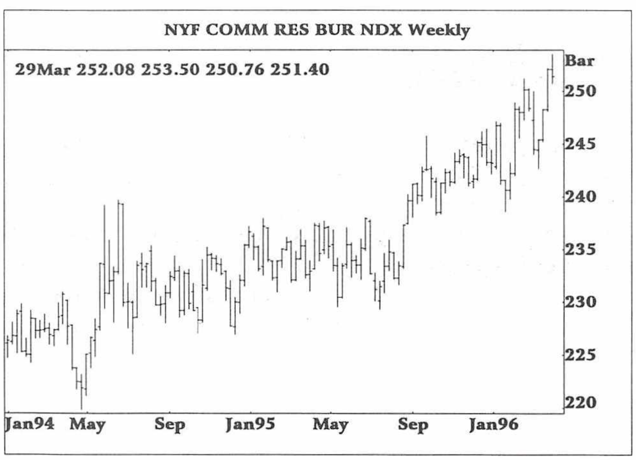
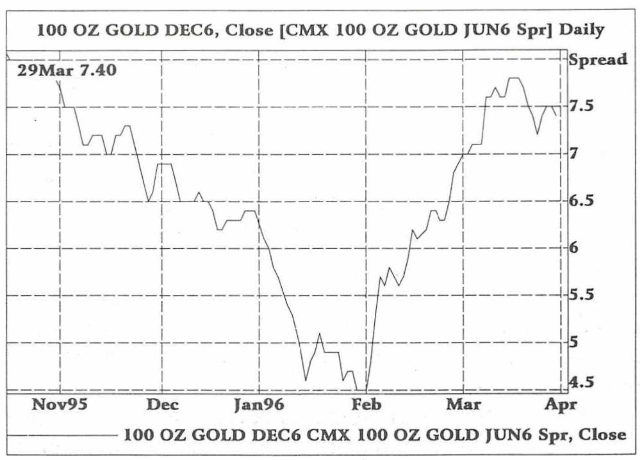


Chart 6



JAPANESE YEN

The troubled yen

The collapse of Taiheiyo Bank, with at least $1.6 billion in unrecoverable loans (a quarter of its total loan book) and Equion Co., a mid-size Tokyo non-bank lender with $1.7 billion dollars of bad loans, highlight the severity of Japan's banking problems. According to the Japan Credit Rating Agency Limited (JCR), Japan's financial system is facing a solvency problem rather than a liquidity problem.

While the minister of finance had estimated that total bad loans were around ¥ 37 trillion as of the end of September for commercial banks and cooperative-based financial institutions, JCR estimates the total to be at least ¥100 trillion. That would require writeoffs of ¥50-¥60 trillion, according to some analysts.

As an example, although the troubled *jusen* housing loans companies are the centre of attention, there are 19,000 non-bank financial institutions that in total hold unrecoverable loans estimated at around ¥40 trillion compared with ¥6.3 trillion at the *jusen*.

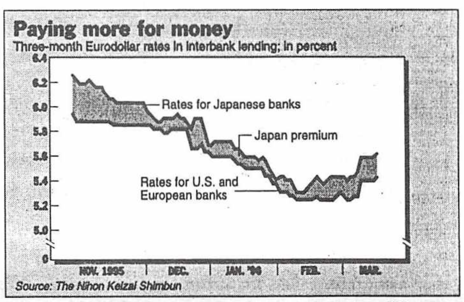
The Diet's inability to deal with a mere $6.5 billion injection of public funds into the *jusen* has begun once again to enervate the global financial community. As a result, the Japan premium — a risk premium imposed on dollar borrowing by Japanese banks — is back (see Chart 7).

The immensity of the problem and the government's inability to deal with it in a quick and expeditious form — recent banking crisis in the Nordic countries, Chile, and Mexico to name just a few over the past 15 years — should show the way before it is too late. If it comes, a banking panic — and the odds of it occurring are growing by the day — will have profound repercussions on the world financial markets. (The exact impact is not easy to determine, because it will depend on the reaction of other central banks.)

With proper planning the government can socialize the banking losses with minimal inflationary consequences. A banking panic, on the other hand, may force the Bank of Japan to inject enormous amounts of liquidity to counter asset liquidation and withdrawals. The effect will be hugely inflationary and will certainly have a devastating impact on the yen.

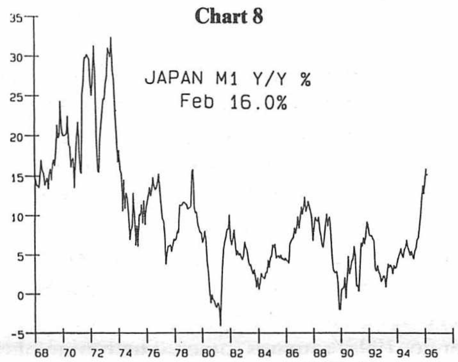
STRATEGY: *The Japanese yen remains an attractive funding vehicle. Borrow cheap yen to buy New Zealand dollars, Australian dollars, and Canadian dollars in that order.*

Chart 7



THE NIKKEI WEEKLY

Chart 8



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CANADIAN DOLLAR

Long, but cautious

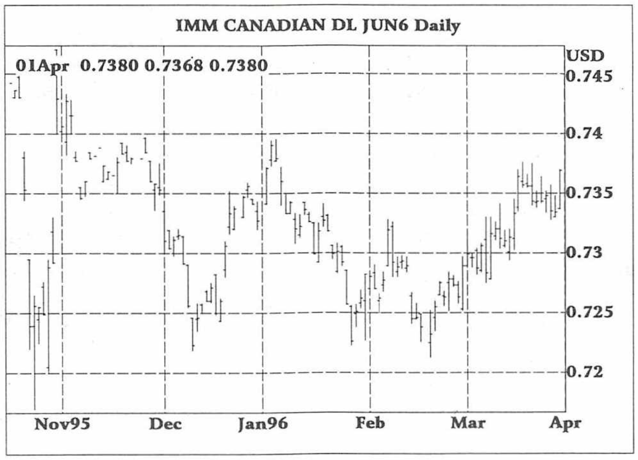
Despite improving fundamentals, the Canadian dollar has made very little upward progress in recent weeks. This can be attributed to the Bank of Canada's aggressive easing policy. For the second time in 2 months, the Bank eased ahead of the Federal Reserve, cutting the band for call money by 25 basis points to 4.75%-5.25%. As a result, Canadian short rates have moved through US rates by 35 basis points, while 10-year yield differentials have narrowed to 135 basis points, the lowest in quite some time.

We are concerned that the Bank is making use of monetary policy for other than price objectives. Negating a nominal exchange rate appreciation by way of easy money can only lead to inflation. As it is, money supply in Canada is beginning to rise at a healthy clip: 9.2% and 5.5% year-over-year for M1 and M2 respectively. Will the Bank allow these aggregates to overshoot?

We remain friendly to the currency but extremely attentive to attempts by the Central Bank to take advantage of its strength.

STRATEGY: *Remain long. Tighten stops to 73.00, basis June '96.*

Chart 9



SOFT COMMODITIES

Corn

The month of March saw a string of statistics that showed nary a chink in the armor of this classic bull market. On March 12 the USDA reported yet another downward revision for ending stocks of corn at 412 million bushels, down from last month's estimate of 457 million bushels.

Last month we used domestic stocks to domestic usage to calculate a stocks-to-consumption ratio of 7%. Since the world's appetite for American corn is insatiable, let's include exports on the usage side, which will leave us with a carryover of just 4.8% of consumption, or about 11 days of supply.

Only a few months ago the calls by private forecasters for ending stocks of just 250 million bushels seemed rather silly. Now as each USDA revision brings us closer to those predictions, those forecasters seem anything but silly.

Speaking of exports, the latest export commitment data show that corn is being gobbled up by foreign customers. Combined shipped and outstanding sales are running at 51.6 million tonnes for the season versus 40.3 million tonnes at the same time last year, an increase of 28%. A little-watched datum is outstanding sales for the next marketing year. So far, foreigners have booked 2.318 million tonnes of corn *vis à vis* only 317,000 tonnes at the same time this year.

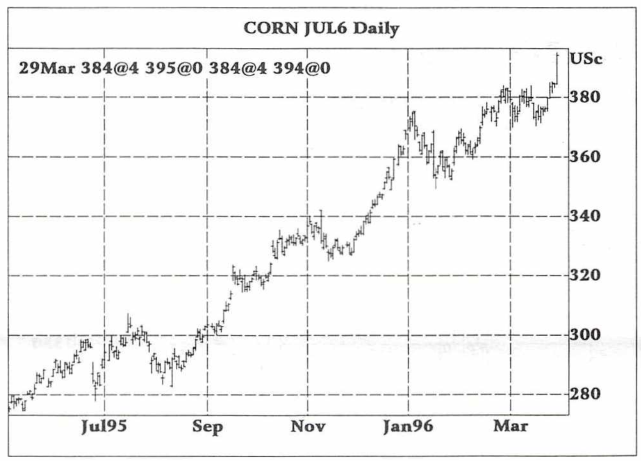
Attractive prices created in a bull market often cause the bull to self destruct, as producers are enticed into increasing production. Early estimates called for US production to return to normal levels, with numbers such as 9.2 billion bushels being thrown around. This would represent a huge increase over last year's pitiful crop of 7.3 billion bushels.

However, the first cold shower has been delivered to this cozy outlook with the USDA's March 29 planting intentions report. Total corn acreage was widely expected to be 81.2 million acres but came in at 79.9 million acres. Although 12% above last year's acreage, it is still a disappointment, given the desperate need for stocks to be rebuilt.

It is difficult at this time, without knowing how much yield per acre will improve from last year's shameful 113 bushels/acre, to assess the crop size. But one thing is certain, if the market was pricing new-crop corn for a 9.2 billion-bushel crop, then the discount of new-crop to old-crop is boldly optimistic and could represent a mammoth buying opportunity.

STRATEGY: *We are in the throes of an historic bull market. Remain long July '96 corn, with protective stops at 3.67, close only.*

Chart 10



Cocoa

With little fanfare and virtually no bullish news, the price of cocoa put together an impressive rally that carried it from an unbreakable floor of $1,200 per tonne to 6-week highs of over $1,300 per tonne. On the way down, the market was fed a steady diet of bearish news. The Ivory Coast is now seen to produce well over a million tonnes this year, where for the longest time it was believed that 950,000 tonnes was quite optimistic.

This brings 1995-96 production, according to the USDA, to 2.71 million tonnes. The USDA pegs consumption at 2.59 million tonnes, for a production/consumption surplus of 120,000 tonnes. What happened to the continued deficits we were relying on to usher in the long awaited bull market?

Not wanting to sound like we're creating excuses but also not wanting to sound like we're backing out, we'll paint the following picture. The production numbers out of the Ivory Coast are hardly reliable. It is well known that exporters change their production numbers depending on whether they need additional financing from banks or pity from government officials for subsidies. So while the additional tonnage may or may not be there this year, the basic supply side fundamental — that their aging trees cannot possibly produce another bumper crop next year — remains intact.

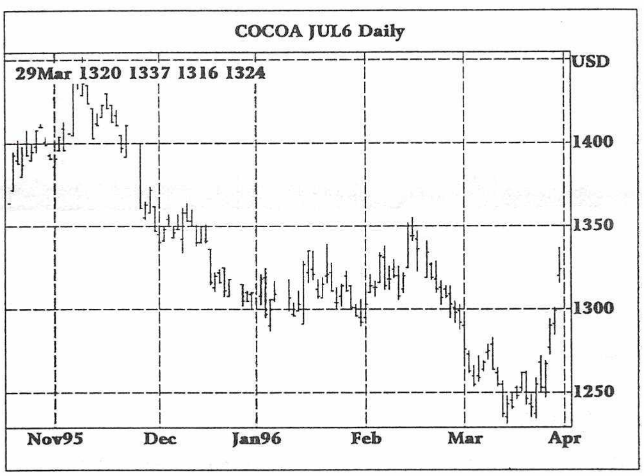
However, we can feel more confident about grindings, because the numbers are out of Western countries and are thus far more accurate. The USDA grinding figure shows a 3% growth in demand from last year. Some of the individual statistics we've seen lately, however, show growth in Western demand to be far greater. The Dutch fourth quarter grind as of the fourth quarter of 1995 was up by 6.31% over the previous year. In the US, figures for January show an increase of bean and product imports of 33% from December and up 40% from last January.

So according to the popular analysts' statistics, while carryover stocks are probably still in the neighbourhood of 40% of consumption, we'll have to rely on price action to guide us. For example, it is quite obvious that commercial buying emerges *en masse* whenever the market gets anywhere close to $1,200 per tonne.

To stretch the technical case a bit further, a glance at a weekly nearest contract chart going back four years, reveals a series of higher lows, indicating that there are always buyers on dips at increasingly higher levels.

STRATEGY: *Stand aside.*

Chart 12 — Cocoa



Coffee

There are two scenarios that could unfold in the coffee market in the coming months. The first one is bullish, the second one is wildly bullish. This is otherwise known as a win/win situation.

Situation A: Just about every analyst considers Brazil's return to normal output for the 1996-97 crop a given. The USDA estimates the crop at 25.5 million bags. As we've pointed out in previous issues, we consider this to be highly optimistic. It remains to be seen what kind of fruit can be produced by trees that were damaged by two frosts and drought. But even working with the assumption that a normal Brazilian crop will ensue, current prices are still a bargain.

Expected increases in output in Colombia will be offset by a decline in output in Indonesia. This would put world production/consumption roughly in balance at abut 96 million bags each but will do nothing for the cause of replenishing a dwindling world stockpile.

Stocks in both producing and consuming nations have been trending downwards for years. World ending stocks for the current season were 32.33 million bags, which represents a 33% stocks-to-consumption ratio. Even with no rise in consumption, next year's ending stocks will remain the same.

This commodity is not accustomed to such a low level of stocks. Since 1980 and before last year's disaster, the average stocks-to-consumption ratio ran consistently close to 50%.

With producing nations still determined to make their retention scheme work, any production problems or unexpected uptick in demand will end the rather long vacation this bull market has taken.

Situation B: The optimism is frivolous, and the Brazilian crop is a disappointment at, say, 22 million bags. This is hardly idle speculation, as we do know that some form of damage has occurred. This will give us a 1996-97 production/consumption deficit of 3 million bags, drawing stocks down further to 29.33 million bags, or 30% of consumption. In the late '70s, the last time stocks reached these levels, the market rocketed to over $3 per pound.

STRATEGY: *Remain long, leaving stops at 109, good anytime.*

Wheat

The wheat market spent most of this month worrying about fungus in Arizona (where there is almost no wheat to worry about) and too much rain in Kansas.

The bearish rationale for the fungus story seemed quite logical: Customers of US wheat, who have been driving the prices through the roof, will back off. In fact 21 countries have fine-print legalese in their trade agreements with the US that allowed them to suspend all shipments of contracted wheat.

The USDA has been working diligently to quarantine any suspected seeds and assure foreign customers that when it's made in the USA, it's okay. Most of the 21 countries have lifted the ban. Those that haven't are turning the matter into a political football.

The scare, as scares go, will disappear and will have no lasting impact on supply/demand fundamentals. As the fungus fear faded and the rains abated, the market showed its brawn. It took the market only two sessions to erase two weeks of losses and make new contract highs.

The weather in the hard red winter growing of areas of Kansas, Nebraska, and Oklahoma is of serious concern. These crops represent over 70% of the total US wheat crop, and they're in trouble.

Ideally, this wheat, planted in the fall and harvested in the spring, likes good snow cover for both moisture and insulation. The winter, however, was harsh, and the fields received more frost and strong winds, which erodes the soil, than it did good old fashioned snow.

To save the crop from disastrous yields, the region needs a nice wet spring for moisture, but it isn't happening. The National Oceanic and Atmospheric Administration (NOAA) says that abnormal dryness is likely to last for the next 3 months in these states. An official at NOAA said that the past 6 months have been the second-driest period in these 3 states in 100 years.

World consumption, as we've pointed out in previous issues, has actually levelled off in the last few years to a steady 550 million tonne demand. The problem has been that years of low prices discouraged excessive planting, and sooner or later bad weather would give us a sub-par crop that would knock the production/consumption balance to a deficit and draw down stocks.

Sure enough, last year's US crop was the worst in years. In fact at the end of this season US stocks, at 346 million bushels, will be the lowest in 20 years. So we now count heavily on this winter wheat crop. A disappointment of two bad crops in a row would be devastating.

While still a bit early to expect the worst, the market price action tells us something about its opinion of the shape the crop is in. Replenishing wheat stocks may have to wait another year.

STRATEGY: *Stopped out at 4.46, basis July '96, as per Hotline Update of March 18. Stand aside.*

Soybean oil

The bull move in grains has pushed prices of just about everything, from widely watched wheat to barely followed oats, to levels not seen in years. There is not much evidence that any of this is about to change anytime soon, as we continue to see data showing shrinking stockpiles and robust demand. Nonetheless, for the value investor, whose speculative appetite is whetted by low risk and fallen angels, are there any scraps left in the pits of Chicago?

In 1994 US grain farmers were reaping record harvests and accordingly depressed prices for their goods. The exception? Soybean oil. A flat Asian palm oil crop created explosive demand for US soyoil; exports rose 52% from the previous year, to 2,680 million pounds.

While the parent beans were sliding to multi-year lows, oil was trying to break through multi-year highs of 30¢ a pound. Completing the equation, the US soy crush was coming off 3 years of poor yields, making oil a scarce commodity.

The move into 1995, however, wasn't that cheery for beanoil. High prices and improving palm oil production in Malaysia and Indonesia put a damper on things and plunged soybean oil into a downtrend whilst the other grains began to enjoy what would soon become a record-smashing bull market.

An examination of the facts reveals a market that may very well be oversold. Even though exports have dropped from last year's record pace, the outlook is bright. US exports dropped 25% this year from last year's record 2,680 million pounds, but still ran 25% above the average of the last 5 years. Projections for next year's exports are for a return to the levels seen last year, at about 2,500 million pounds. Although the gap has recently narrowed, beanoil had been trading at a discount of $40 per tonne to palm oil, which piqued the interest of foreign buyers.

One of the most interesting statistics about the vegetable oil market that seemed to be glossed over by US analysts is the Canadian rapeseed crop. Canola oil, produced from rapeseed, is a major player in the global oilseed market.

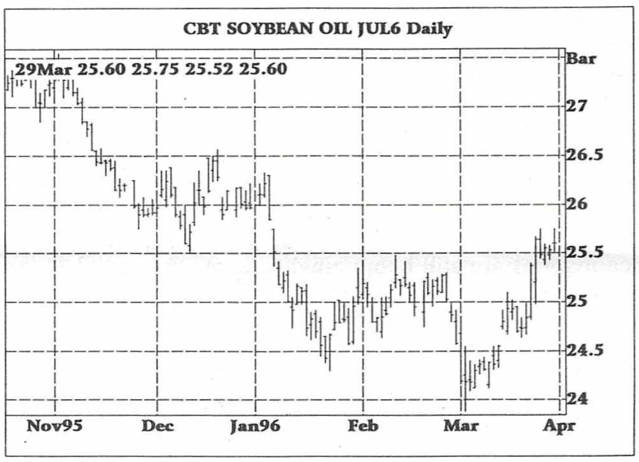
Canadian farmers are going to be switching a huge amount of acreage from rapeseed to wheat this year to take advantage of soaring wheat prices. In fact, on March 27, Statistics Canada reported that canola will suffer a 29% drop in acreage to only 9.34 million acres. That's a lot of oil lost.

Beanoil remains undervalued *vis à vis* the complex, the other grains, and other vegetable oils. There may be some opportunity left in these markets after all.

STRATEGY: *Buy July '96 soybean oil at the market, placing stops at 24.90, close only.*

— Sholom Sanik

Chart 14



FRIEDBERG CAPITAL MARKETS

Digital Equipment Corporation

Security: Common stock
Exchange: New York Stock Exchange (DEC)
Current price: $55.00
52-week range: $36.00-$74.75
Shares outstanding: 153 million
Market capitalization: $8.4 billion

The restructuring of Digital Equipment Corporation (DEC) over a year ago has produced five consecutive quarters of positive earnings. The plan involved a reorganization that would enable the company to deliver quality products and services with a more efficient and responsive organization.

DEC has made much progress toward its goals; however, recently the company announced that it will experience lower-than-expected third-quarter PC sales. Furthermore, the announcement included a warning from management that fourth-quarter earnings per share estimates were aggressive. As a result, the company's stock fell 17% to the $50 to $53 range.

We feel that DEC is fairly valued at this time. But continued strong demand for client server technology combined with organizational improvements and further cost cutting could significantly enhance the value of DEC in the future.

The company's reorganization sought to improve on its ability to deliver solutions to customer needs and improve flexibility to capitalize on a dynamic computing environment. DEC has formed independent business units that compete within specific market segments and are accountable at that level. This strategy will promote efficiency by allowing the organization to become more focused on key segments that will provide the most opportunity in the future. The company has also sought to leverage its key competencies through strategic alliances with other company's such as Microsoft and Oracle.

Digital's Alpha systems continue to be the driving force behind the successful performance, representing about 28% of product sales and commanding solid margins. DEC product lines include arguably some of the highest quality equipment the industry has to offer. Alpha server technology is designed to support multiple operating systems, to integrate with other systems in an open computing environment, and tackle the most complex database and scientific applications.

Financial performance

The last five quarters have provided continued year-over-year growth in revenues for the company. The lion's share of this growth has come from products sales. Service has been slow to contribute, because declining maintenance revenues from VAX systems continue to offset growth in system integration and strategic consulting.

Most of the product growth has come from the Alpha product group followed by Intel PCs, while VAX product revenues continue to decline. Besides the slowdown in PC sales, management has suggested that revenue growth in other product groups and services will continue as expected.

Product gross margin at 32.6% remains higher than anticipated, because certain lines within the Alpha product group continue to command larger-than-expected margins and a more favorable product mix was realized — that is, a mix shift from lower margin to higher margin products. Service margins are still being pinched somewhat at 32.7% and are lower than previously anticipated. The total gross margin remains at approximately 32.7%, which is consistent with previous expectations.

As part of the restructuring, the company outlined its goals for its selling, general and administrative expenses (SG&A) as well as research and development (R&D) costs. The SG&A and R&D objectives were 15%-18% and 7% of revenues respectively. At this time R&D expenses are slightly below 7% of revenues; however, SG&A are roughly 21.5% of revenues.

The 15%-18% range is still the company's long-term objective for SG&A. Its 18-month to 24-month target has these expenses at less than 20% of revenues. Further progress toward its target will enhance corporate earnings substantially and bring operating and profit margins more in line with its competitors.

Industry comparison and summary

Financial ratios for DEC, IBM, and Hewlett Packard (HP) can be found in Chart 15. The financial position of the three companies is comparable in terms of liquidity, leverage, fixed charge, and turnover. This comparison, however, brings the major issue of high operating expenses to the foreground. The ratios suggest that DEC's profitability compared with other firms is substantially lower and most likely the cause of lower price multiples.

We feel the company's profitability can be enhanced. The greatest opportunity for DEC lies in its ability to lower its SG&A expense relative to revenues generated. DEC trails its competitors in both sales per employee and net income per employee, indicating that there is room to improve the company's efficiency. Although some of difference may be explained by DEC's orientation toward more labor-intensive service, the employee ratios trail the competition by a substantial amount.

Price ratios also indicate that there is an opportunity to capitalize on increased margins. DEC's price-earnings ratio, based on 12-month trailing earnings, is higher than its competitors, yet the price-to-sales ratio is lower. This may suggest that the market anticipates that the company will generate more future earnings through cost-cutting than through revenue generation. Nevertheless, in absolute terms the company has a lower value based on price-to-sales and price-to-book. Again, the reason is the lower profits generated per sales dollar.

To illustrate the potential gains, a reduction of SG&A expenses was incorporated into a conservative FY '96 forecast as shown in Chart 16. The company has stated goals indicating it plans to decrease these expenses by at least 2% within a 2-year period.

Reducing SG&A to 19% in this period would imply a P/E multiple of 10x using current EPS figures. Reaching the targets of 18% and 15% would imply P/E multiples of 9x and 6x respectively. It is obvious that reaching these goals could enhance earnings and lead to a substantial increase in the stock price.

Based on analysts' current *lowest* earnings per share estimates, a reduction of SG&A to 19% in 2 years could return 20% to 30% annually to the investor, depending on what multiple the stock trades at. Since expense reductions of 2% to 3% would bring margins back in line with its competitors, it was assumed that the stock should trade at similar multiples. This is by no means a forecast. However we feel it does illustrate the potential gains if the company meets its operating expense targets. Margin improvements will enhance the scenario further.

Concerns regarding the slowdown in PC sales are tempered by the fact that they represent approximately 18% of total sales and have the lowest margins of all DEC product lines and services. Also of concern is a commerce department survey conducted in November of 1995, suggesting that lower capital spending in 1996 will adversely affect high-tech purchases. On the other hand, there is some indication that corporate customers are reducing their current expenditures in anticipation of the new release of Windows NT operating system.

STRATEGY: *DEC provides a high-quality product. Continued growth in demand for client server technology will enhance the company's performance. The reorganization and staff cuts have made the company more efficient. As a result, we've seen some reductions in operating expenses thus far, with SG&A expenses still ultimately targeted at 15% to 18%. Our analysis suggests that reductions in operating expenses of this size will eventually surface in rising share prices. We advise placing a stop at $49 ($1.25 below the recent low), as this would represent a deviation from a major trend as well as a change in market sentiment and a lower multiple.*

Chart 15

	DEC	HP	IBM
Revenue Split			
% Service Revenue	41.00%	13.65%	34.00%
% Product Revenue	59.00%	86.35%	66.00%
Profitability Ratios			
Gross Margin	32.35%	36.05%	42.24%
Operating Margin	3.36%	11.42%	10.47%
Net Profit Margin	2.91%	7.80%	5.65%
SG&A to Sales (incl R&D)	28.91%	24.53%	31.66%
Employee Ratios			
Sales per Employee	235.68	308.10	319.24
Net Income per Employee	7.14	25.62	18.54
Financial Performance			
Current Ratio	1.9	1.5	1.3
Total Debt to Total Cap	20.90%	27.01%	49.10%
Debt to Assets	10.20%	17.59%	26.94%
Total Liabilities to Total Equity	161.80%	110.37%	258.08%
EBITDA-cap exp/interest	10.7	23.0	13.4
A/R Turnover - days	75.8	65.4	65.4
Inventory Turnover - days	73.0	98.3	46.3
Total Mkt Value to EBITDA	10.5	8.6	7.0
Price Ratios			
Price to Earnings	21.0	18.9	15.6
Price to Sales	0.6	1.6	0.9
Price to Book	2.2	3.9	2.8
12 month EPS	2.62	4.98	7.22

Chart 16

			Industry Low
1996 Sales			15,200
EPS estimates			2.70
Shares Outstanding			157
Total Earnings Estimated			**423.90**
SG&A % of Sales Included in Forecast			21.60%
Incremental Earnings with SG&A % of Sales =		19.0%	395.20
Revised Earnings			**819.10**
Revised EPS			5.22
Implied P/E @ Stock Price =		55.00	10.5
Stock Price @	P/E	12	62.61
Stock Price @	P/E	15	78.26
Stock Price @	P/E	18	93.91
Implied Price to Sales @	P/E	12	0.65
Implied Price to Sales @	P/E	15	0.81
Implied Price to Sales @	P/E	18	0.97
Time Horizon 2 Years			
Annual Return @	P/E	12	6.69%
Annual Return @	P/E	15	19.28%
Annual Return @	P/E	18	30.67%
Time Horizon 3 Years			
Annual Return @	P/E	12	4.37%
Annual Return @	P/E	15	12.34%
Annual Return @	P/E	18	19.31%
Time Horizon 4 Years			
Annual Return @	P/E	12	3.29%
Annual Return @	P/E	15	9.22%
Annual Return @	P/E	18	14.31%

Gold Bull/Yen Bear Note

Recall that the value of the gold bull/yen bear note, issued by the Kingdom of Denmark, varies directly with the Japanese yen (JY) in terms of US dollars (US$). As the JY appreciates, the value of this note will decrease. In order to offset the impact of an appreciating JY, the note's coupon was structured so that it will increase if this occurs.

Relatively higher expected inflation in the US will cause US interest rates to increase relative to Japanese rates. As well, relatively higher expected inflation in the US will cause the US$ to depreciate relative to the JY according to the purchasing power parity.

In following with this line of thought, strength in the JY (resulting from lower inflation) could be hedged by earning a return on the increase in the interest rate differential between the US and Japan. Therefore, the coupon structure of this note incorporates the spread between 5-year US$ and 5-year JY swap rates to offset an appreciating JY. In short, as the JY appreciates, this swap spread will widen and increase the note's coupon. A hedge of the Japanese yen using swap rate differentials, however, will not be perfect.

Since settlement of this note, the correlation between the JY and the swap spread referred to above (-.62) has been somewhat greater than that calculated using a longer 7-year horizon (-.36). This would suggest that over the term of this note, the investor is receiving a greater amount of downside protection than it would if the correlation was lower, as it seems to be over the long term.

Chart 17 shows the effectiveness of the coupon in terms of offsetting the appreciation of the JY. Note that the gains are calculated using two values for the JY. The current value is used to calculate the gains for the entire term and the average is used to account for shorter holding periods.

It clearly was more beneficial to hold this note from the outset. It would have provided larger coupons due to a strong JY. Yet since the JY has returned to its original value, the holder of the note has not suffered any loss. Even if the note was not held for the entire period, the structure of the coupon has removed, on average, approximately 30% of the downside associated with an appreciating JY.

The absolute benefit of the coupon structure can be seen in Chart 18. In some cases, the additional coupon payment over and above the borrower's cost of funds is quite substantial. It is this amount that has contributed to offsetting an appreciating JY.

— Peter O'Sullivan

Chart 17

Yen Value at Time of Issue	¥/$US	106.00	¥/$US	106.00
Yen Value at:	¥/$US	95.69 *(period avg)*	¥/$US	106.43 *(current)*
Total Return on Yen		-9.73%		0.41%
Annual Return on Yen		-4.80%		0.19%
Excess Annual Return from Coupon (over funding cost of Libor - 55bp)		1.38%		1.38%
Net (Loss) Gain from Yen Position		**-3.42%**		**1.57%**

Chart 18

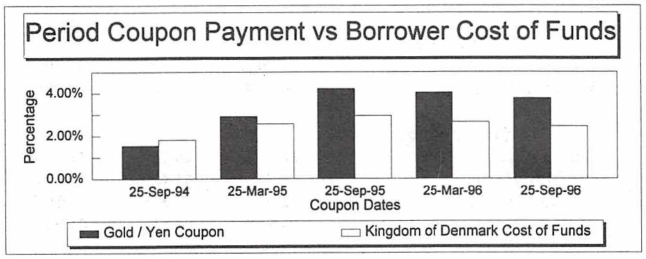


Chart 19 — Breakeven exchange rates for US$-based investor

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$, ECU, CD, SAR, ARG, and CZK) or revalue for DM, SF, FFr before the interest rate advantage/disadvantage is overcome by currency depreciation/appreciation. **Rates as of March 29, 1996.**

	U.S. $	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	CZECH KORUNA
1 year	5.40%							Cr. Lyon '96 yields 4.65 (FFr/US 4.9972)						
2 year	5.79%	New Zealand '98 yields 8.04% (US/NZ 0.6534)								Eksp. 7.75% '97 yields 5.88% (CDN/US 1.3640)				
3 year	5.93%		Denmark '98 yields 3.83% (DM/US 1.3903)											G.E. '98 yields 9.37% (CZK/US 29.9809)
4 year	6.05%	Tranz Rail '99 yields 9.49% (US/NZ 0.5998)	World Bk. '99 yields 4.83% (DM/US 1.4096)	G.E. 99 yields 2.67% (SF/US 1.0454)										
5 year	6.11%								UK '01 yields 6.37% (US/ECU 1.2410)				Pre 1: BOCON yields 16.50% (ARG/US 1.5953)	N.I.B. '00 yields 9.93% (CZK/US 32.5092)
6 year	6.15%													
8 year	6.35%													
12 year	6.41%										ESCOM '08 yields 14.94% (SAR/US 0.1255)			
Spot Exchange Rate	–	0.6815	1.4764	1.19	107.075	5.702	1.5262	5.033	1.2563	1.3617	0.2513	1.568	1.00	27.24

*For example, since a US$-based investor would receive 357 basis points (949-605) by holding the Tranz Rail NZ$ bond, the NZ/US can depreciate to .5998 from the present spot exchange rate of .6815 over the next 4 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 20 — Recommended current portfolio allocations

1.	Queensland (Gold Bull)	15%	5. New Zealand Gov (8%)	20%
2.	St Luke CV	10%	6. Fletcher NZ	20%
3.	Czech Koruna	10%		
4.	Pre-1	25%		

Chart 21 — FOREIGN CURRENCY BONDS

DATE: March 29, 1996 *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		99.35	100.20	3.33		May-07
World Bank 5 7/8% 4/02/97 RRSP eligible		101.25	102.10	3.26		Feb-04
World Bank 7 1/4% 13/10/99 RRSP eligible		106.80	107.65	4.83		Oct-13
World Bank 9% 13/11/00 RRSP eligible		116.90	-	-		Nov-13
Kingdom of Denmark 6 1/8% 15/04/98		103.05	103.90	4.09		Apr-15
Argentina 8% 5/10/98		102.80	-	-		Oct-05
Kgdm. of Spain (6 Mo. LIBOR-1/16) 29/6/02 (semi)		99.70	100.00	-	3.6875	Jun-28
CZECH REPUBLIC KORUNA BONDS						
General Electric Cap. Corp. 10.5% 23/10/98		101.50	102.35	9.37		Oct-23
Nordic Inves. Bk 10.625% 10/11/00		101.50	-	-		Nov-10
ITALIAN LIRA DENOMINATED BONDS						
Nordic Inves. Bk 12 3/8% 19/04/96		99.40	100.25	6.02		Apr-19
SWISS FRANC DENOMINATED BONDS						
General Electric Cap. Corp. 4 3/4% 2/7/98		103.90	-	-		Jul-02
General Electric Cap. Corp. 4 1/2% 17/12/99		105.50	106.35	2.67		Dec 17 1996
DANISH KRONE DENOMINATED BONDS						
Kgdm. of Denmark 9% 15/11/96		102.20	103.05	3.83		Nov-15
ECU DENOMINATED BONDS						
United Kingdom 9 1/8% 21/02/01		110.40	111.25	6.37		Feb-21
BRITISH POUND DENOMINATED BONDS						
Kdgm. of Sweden 8 3/4% 29/5/96		99.75	-	-		May-29
FRENCH FRANC DENOMINATED BONDS						
Credit Lyonnaise 9 1/2% 23/12/96		102.45	103.30	4.65		Dec-23
JAPANESE YEN DENOMINATED BONDS						
World Bank 5 3/4% 7/8/96 RRSP		101.05	101.90	0.22		Aug-07
CANADIAN DOLLAR DENOMINATED BONDS						
Eksportfinans 7 3/4% 5/11/97		101.45	-	-		Nov-05
Royal Bank of Canada 9 1/8% 7/1/97 RRSP eligible		101.95	103.20	4.67		Jan-07
Ontario Province 10 5/8% 15/7/98 RRSP eligible		107.45	-	-		Jul-15
SOUTH AFRICAN RAND DENOMINATED BONDS						
ESCOM 11% 1/6/08 (semi)		77.30	78.15	14.94		Jun-01
AUSTRALIAN DOLLAR DENOMINATED BONDS						
Commonwealth Bk. of Australia 9 3/4% 15/5/96		100.30	101.15	-		May-15
NEW ZEALAND DOLLAR DENOMINATED BONDS						
World Bank 12.5% 25/7/97 (semi) RRSP eligible		105.00	105.85	7.71		Jul-25
New Zealand Gov't 10% 15/7/97 (semi)		101.10	101.95	8.35		Jul-15
New Zealand Gov't 8% 15/7/98 (semi)		99.05	99.90	8.04		Jul-15
Fletcher Challenge 10.75% 15/12/97 (semi)		101.60	-	-		Jun-15
Fletcher Challenge 10.15% 30/11/98 (semi)		101.20	-	-		May-30
Tranz Rail Ltd. 10% 15/10/99 (semi)		100.65	101.50	9.49		Apr-15
DB Group 7% 30/6/96 (semi) matures @ 85		85.90	86.75	-1.34		Jun-30
Trans Tasman 9% 27/6/99 (semi)		94.00	94.85	11.20		Jun-27
St. Luke 8.7% 1/4/99 (semi) CV @ 1.00 p/sh		124.00	125.00	10.04		Apr-01
ARGENTINEAN PESO DENOMINATED BONDS	PAR VALUE			IRR		
Bocon Pre 1: 1/4/2001	133.4079	93.35	95.10	16.50		May-01-97
U.S. DOLLAR DENOMINATED FIXED CONV. BONDS						
Burnup & Sims 12% 15/11/00 CV@16.79 p/sh (semi)		98.25	99.75	12.06		May-15
Atari Corp. 5 1/4% 29/4/02 CV@16.31 p/sh		60.75	62.25	15.20		Apr-29
Coeur D'Alene 6% 10/6/02 CV@ 26.00 p/sh		98.25	99.75	6.04		Jun-10
Glycomed 7 1/2% 1/1/03 CV@14.06 (semi)		78.25	79.75	11.95		Jul-01
U.S. DOLLAR DENOMINATED FIXED RATE BONDS						
Queensland Tres. (Gold Bull) 2% 4/3/98		96	98	-		Mar-04
World Bank 7 1/8% 27/9/99 (semi) RRSP eligible		102.95	103.80	5.90		Mar-27
Farm Credit Corp 7 3/4% 10/06/96 RRSP eligible		100.25	-	-		Jun-10
T.W.A. 12% 3/11/98 (semi)		98.40	99.25	-		N/A
U.S. DOLLAR DENOMINATED FLOATING RATE NOTES						
Kgdm. of Denmark 25/3/97 (Gold call, JY put),(semi)		92.60	-	-	7.534	Sep-25
United Kgdm. 30/9/96 3 mo.LIBID-1/8 (qtly),callable @100		99.86	100.16	-	5.4375	Mar-29
Canada Gov't 10/2/99 3 mo. LIBOR - 1/4 (qtly), callable @ 100 RRSP eligible		99.48	99.78		5.0547	May-13
Bocon 1/4/01 (30 day LIBOR) starts paying May 1,'97	PAR: 125.2402	103.95	104.80	12.57		May-01-97
Argentina: Series L:FRB 31/3/05, 6 mo. LIBOR+13/16 (semi)		71.35	72.85	13.56	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

Tuesday, February 27, 1996:
Good afternoon for Tuesday, February 27. There are no changes or new recommendations.

***Flash Update:* Thursday, February 29, 1996:**
Good afternoon for Thursday, February 29, 5:35 pm. This is a flash update. Buy June Canadian dollars at the market, placing stops at .7200, good anytime.

Friday, March 1, 1996:
Good afternoon for Friday, March 1. We have one new recommendation: Buy May silver at the market, risking 546.00, good anytime. May silver closed today at 554.00.

The following is a recap of this week's recommendations: On Thursday, February 29, via flash update, we advised to buy June Canadian dollars at the market, placing stops at .7200, good anytime. This morning June Canadian dollars opened at .7319.

***Flash Update:* Monday, March 4, 1996:**
Good afternoon for Monday, March 4, 5:15 pm. This is a flash update. We have 2 new recommendations: Buy June S&P at the market, placing stops at 640.00, good anytime.And cover short June T-bond positions at the market, cancelling the 118.00 stop.

Friday, March 8, 1996:
Good afternoon for Friday, March 8. We have 2 new recommendations: Raise stops on long July corn to 3.67, close only, from 3.59, and raise stops on long July wheat to 4.46, close only, from 4.40.

The following is a recap of this week's recommendations.

- On Monday, March 4, via flash update, we advised to buy June S&P at the market, placing stops at 640.00, good anytime.
- On Tuesday, March 5, June S&P opened at 655.05. We also advised to cover short June T-bond positions at the market, cancelling the 118.00 stop. On Tuesday, March 5, June T-bonds opened at 115.25.

***Flash Update:* Tuesday, March 12, 1996:**
Good morning for Tuesday, March 12, 11:00 am. This is a flash update. We have two new recommendations: Buy June T-bonds at the market, presently trading at 111.12, placing stops at 110.00, good anytime. Also, buy June S&P at the market, presently trading at 640.40, placing stops at 632.00, good anytime.

Friday, March 15, 1996:
Good afternoon for Friday, March 15. The following is a recap of this week's recommendations:

- On Tuesday, March 12, via flash update, we advised to buy June T-bonds at the market, then trading at 111.12, placing stops at 110.00, good anytime, and to buy June S&P at the market, then trading at 640.40, placing stops at 632.00, good anytime.

***Flash Update:* Monday, March 18, 1996:**
Good afternoon for Monday, March 18, 5:20 pm. This is a flash update. Buy July coffee at the market, placing stops at 109.00, good anytime.

***Flash Update:* Friday, March 22, 1996:**
Good morning for Friday, March 22, 8:30 am. This is a flash update. We have 2 new recommendations. Buy June gold at the market, presently trading at 401.30, and buy July silver at the market, presently trading at 568.00.

Friday, March 22, 1996:
Good afternoon for Friday, March 22. We have two new recommendations: Raise stops on June S&P to 640.00, good anytime from 632.00, good anytime. And raise stops on November soybeans to 7.10, good anytime from 6.89, close only.

The following is a recap of this week's recommendations.

- On Monday, March 18, via flash update, we advised to buy July coffee at the market, placing stops at 109.00, good anytime.
- On Tuesday, March 19, July coffee opened at 118.10.
- This morning, via flash update, we advised to buy June gold at the market, then trading at 401.30, and to buy July silver at the market, then trading at 568.00.

Tuesday, March 26, 1996:
Good afternoon for Tuesday, March 26. There are no changes or new recommendations.

Friday, March 29, 1996:
This is a complete market summary since our last market letter dated February 25, of all liquidations of open positions and new recommendations that remain outstanding:

- On Thursday, February 29, via flash update, we advised to buy June Canadian dollar at the market, then trading at .7319, placing stops at .7200, good anytime.
- On Monday, March 4, via flash update, we advised to cover short June T-bond positions at the market, then trading at 115.25, cancelling the 118.00 stop.
- On Friday, March 8, we recommended to raise stops on long July corn to 3.67, close only, from 3.59, and to raise stops on long July wheat to 4.46, close only, from 4.40.
- On Tuesday, March 12, via flash update, we advised to buy June T-bonds at the market, then trading at 111.12, placing stops at 110.00, good anytime, and to buy June S&P at the market, then trading at 640.40, placing stops at 632.00, good anytime. The stop was then raised to 640.00 on March 22.
- On Monday, March 18, via flash update, we advised to buy July coffee at the market, placing stops at 109.00, good anytime.
- On Friday, March 22, via flash update, we advised to buy June gold at the market, then trading at 401.30, and to buy July silver at the market, then trading at 568.00. And, to raise stops on November soybeans to 7.10, good anytime, from 6.89, close only.

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