FRIEDBERG'S

COMMODITY & CURRENCY COMMENTS

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Musings on a quarter century of comment

There is something immensely humbling in reading one's own comments and suggestions proffered over a quarter of a century. Such grandiloquence, such certainty, so many forecasts that went awry but that at the time seemed all but inevitable. The maturing perspective of time makes us smile at the gravity with which we endowed past events and at the solemnity of our analytical trade.

Did we not know that the world will muddle through, and prosper at that? Did we not realize that if *they* won't let it happen, it simply will not happen? Or, at the very least, not yet? Lacking this basic knowledge, we found ourselves correctly diagnosing a problem, correctly anticipating a crisis — and even at times profiting thereby — but incorrectly overstaying our hand, the result of seeing the world through apocalyptic lenses.

It now seems to us that the end-of-the-world-is-coming-now was not only a reasoned approach in many cases, but a fervent hope. Bad guys are supposed to be caught and punished. Bad banks are supposed to fail, bad monetary policy is supposed to lead to the extremes of inflation and deflation, bad fiscal policy to default, lack of well-defined property rights and the rule of law to capital flight, and so on.

In the ideal world, the holders of Tesobonos should have been forcibly restructured, Citibank and Chase (just to name a few of the go-go lenders of the '80s) should have gone to the wall, the Italian and Turkish governments should have run out of willing lenders, and so on. Punishment would have taught virtue. Virtue would make this world a better place to live in.

Instead, there never was an end of the world and no lessons were taught. Bad behavior does pay. In banking parlance, we ratcheted exponentially upwards the level of moral hazard.

Should we have cared? In retrospect, no, although I seem to detect in all these writings a hopeless moralistic streak that mars a colder, more realistic and perhaps more practical vision of the world as it really is.

Midway through our journey, our monetary watch began to falter. Grandstanding about the evils of easy money, we failed to appreciate the almost mystical connection between easy money and optimism. And at times we even failed to appreciate the therapeutic powers of optimism.

The depressing price inflation of the '70s and early '80s gave way to the joys of asset inflation. This powerful wave of optimism colored all kinds of expectations: bids for Nigerian and Bulgarian paper; a stock market of sorts in the former Soviet Union; hope in the Brazilian Plano Real; serious investments in China and other Southeast Asian nations where such words as transparency and disclosure do not even appear in their lexicons.

And yet, in a sort of self-fulfilling fashion, this very unreal optimism did have a beneficial impact: The major Eastern European countries successfully integrated into Europe and handsomely rewarded their early wide-eyed investors; the well advertised global trade war ended with a whimper; and what else? A World Trade Organization. Menem and Fujimori, taking their cue from Chile and eschewing ECLA, UNCTAD, and 50 years of protectionism and import substitution, chose economic liberty. Mexico preserved NAFTA despite one of the most severe depressions on record. China successfully reined in a runaway inflation with the "capitalistic tools" of tighter money. The world's capital markets opened up for the first time ever to millions of investors.

In reviewing the hundreds and thousands of pages of Comments that go back to the Spring of 1971, a number of points stand out. On a negative note, our inability, as men-

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

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tioned, to appreciate the capacity of particular authorities, countries, or the world to muddle through once a crisis had already erupted. Most of the time, the problems were pushed into the (far away) future: Either time would dilute the problems or the losses would be socialized. And yet, it worked.

On the rare occasion when they would bite the bullet, unusual investment opportunities arose. Unfortunately, they were too few and far between. On a positive note, we compiled a good record for anticipating a crisis or a favorable economic event. At times we were rewarded in fairly short order. At other times, and more often than not, however, events were telescoped and the wait was measured in months and even years. The safest bets were the ones that allowed us to ride the big trends with a conviction built upon carefully thought out arguments. The signs of a winner? A clear argument, usually only one reason, particular to the market in question — as opposed to a macro call — and one that came early in the move.

The reader may believe that this writer, as he sits down to write, already knows what he will say, that the writer will merely lecture the invisible audience. If the reader thought so, he'd be mistaken. The physical absence of the reader forces the writer to pour out his thoughts and lay bare the inner recesses of his mind in an attempt to convey his ideas in the clearest possible manner. This exercise uncovers insights that, were it not for the reader, would have remained buried in the writer's subconscious. In this manner, it is the reader who has been the inspirational source of all the writer's insights.

There are two additional reasons to be thankful to you, the reader. You keep the writer honest — no small feat. And by forcing him to array the arguments pro and against, you fine-tune his sensitivity so that he may catch the slightest change in the wind.

It truly could not have been done without you.

— Albert D. Friedberg

CURRENCIES

Will the yen's droop become a drop?

The bear case for the yen is becoming more solid. Economic activity has quickened somewhat, as the consumer has loosened up (see Chart 1). Monetary authorities have kept their foot on the accelerator, allowing M1 to expand by more than 15% year over year. Broad money growth, however, remains stagnant at 3.2% year over year.

In recent days government officials have indicated that easy money conditions will persist until progress becomes more visible. Significantly, the slight pickup in economic activity has had a disproportional impact on imports, which have surged over the past few months. As a result, the narrowing of the trade surplus appears to be accelerating (see Chart 2). The 12-month trade surplus totals through April will be down almost 40% from the peak of ¥14.1 trillion in April 1993.

The Japanese economy's higher propensity to consume at such a low level of economic activity gives rise to the faint, for now, possibility that in the not-too-distant future Japan's mythical trade surplus will disappear. Whether it does or not, the narrowing trend is unmistakable. Coupled with the easy money policy the Bank of Japan designed to encourage short-term capital outflows, the drooping yen may yet experience a hard fall.

STRATEGY: *In recent issues we suggested borrowing yen and carrying attractively priced assets such as New Zealand and Australian dollar bonds. Translating this into a currency position would have implied a spread: selling yen and buying New Zealand and/or Australian dollars. As the yen's weakness becomes more pronounced, we are now willing to take on a slightly more prosaic spread: short yen versus long deutschemark.*

Chart 1

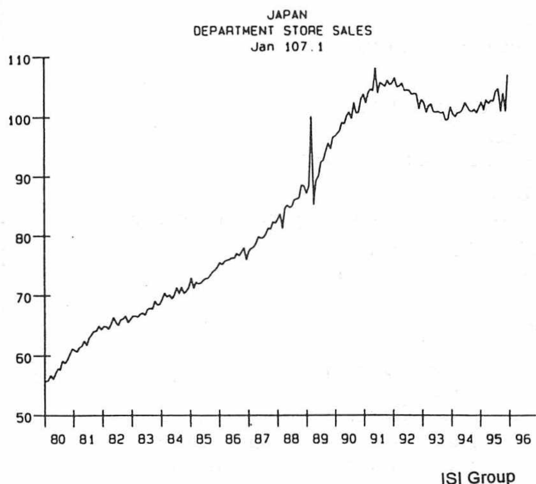
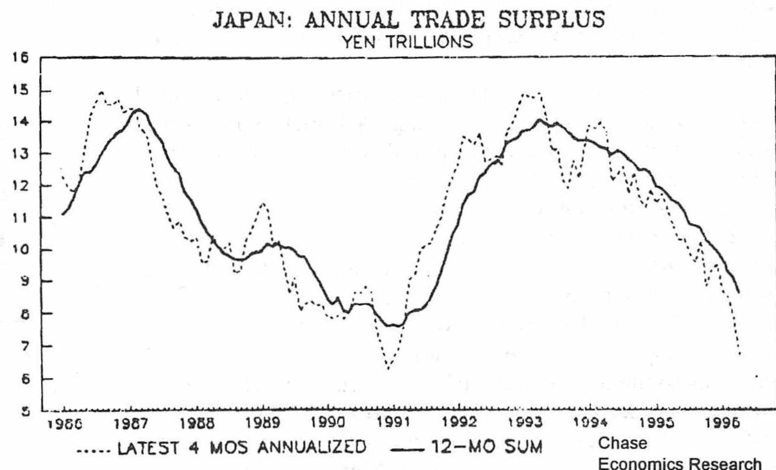


Chart 2



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THE AMERICAS

Clinton's bailout was no favor to Mexicans

By Allan H. Meltzer

On Monday [Jan. 30, 1996] Mexico repaid the U.S. $1.3 billion of the loans made last year during the peso crisis. From all the hype, one might assume that the crisis has passed and that the Mexican people are enjoying prosperity. If the U.S. Treasury and the International Monetary Fund believe this story, why not cancel the additional funding available under the $20 billion loan package extended to Mexico?

Yes, Mexico is once again able to borrow in the international debt markets. Therefore, it can make the repayment, which is primarily an exchange of U.S. credit for German credit. But Mexicans themselves continue to suffer the consequences of devaluation: high unemployment, high inflation and an extraordinary risk premium in interest rates reflecting market skepticism about Mexico's future.

The direct causes of Mexico's problems in 1994 are well known and thoroughly understood: Mexico's central bank — the Bank of Mexico — failed to raise interest rates enough to slow money growth and stop a run on the currency.

Back in 1994, the Mexican government increased spending and lending — much of it off-budget. And the central bank pumped in money to hold down the rise in interest rates on government debt. Inflationary policies did not end with the August election, and neither the incoming nor the outgoing government gave a sign that inflationary policies would be checked. The 1995 budget plan showed no reduction in spending and no plan to tighten policy.

The allegation that foreign investor capital flight caused the drop in reserves is unfounded. Rapid money growth came at a time when Mexicans themselves were showing their concern about Mexico's policies. Mexican residents, on balance, stopped buying government securities in February 1994. In contrast, foreigners increased their holdings of Mexican government securities in 1994 by 50%, to more than 100 billion pesos. Foreigners continued to purchase Mexican debt as late as December. Large net sales by foreigners did not begin until February 1995, after the devaluation.

After the Mexican government devalued the currency, the IMF and the U.S. government loaned money to Mexico on the pretext that they were (1) helping Mexico and (2) preventing an international financial crisis. Both claims are false. Most of the loans were used to repay holders of Mexican government bonds who were speculating on the currency while raking in large spreads over lower-risk G-7 bonds. The loans mainly enriched the speculators. The Mexican population suffered a decline in wealth and income.

A global financial system that had survived several devaluations of the British pound, the French franc and the U.S. dollar was surely able to cope with the consequences of another in a series of Mexican devaluations. Arguments to the contrary were never more than a propaganda barrage from the U.S. government and the financial services industry to get a reluctant U.S. Congress and a generally hostile U.S. public to approve new loans to Mexico, thereby bailing out speculators. This strategy failed, and the U.S. government resorted to back-door, off-budget financing and help from the IMF.

A common explanation of the crisis is overvaluation of the peso after adjusting for differences in inflation between Mexico and the U.S. This explains 7% to 10% of the real appreciation of the peso since 1992, a small part of the 40% devaluation in 1994.

Much more telling, I believe, was the inflationary policy of the Mexican government. Starting in June 1994, each month's producer prices showed an increase over 1993, and each month's reported inflation was higher than the previous month's. By December 1994, the annual increase in producer prices was 9.1%, nearly twice the rate of December 1993.

Mexicans had enough experience with inflationary policies to know that the likely aftermath was devaluation. The rational response was to take the money and run for dollars.

Mexico could have avoided devaluation if it had ended its inflationary policies after the election, even as late as mid-November. The proper policy was to announce reductions in spending and money growth. The latter would have required higher interest rates and possibly a recession, but interest rates would not have reached the peak levels of early 1995 — 80% to 100%. Any recession would have been far less severe than the deep recession that followed the devaluation and that continues to this date.

Mexico used most of its reserves and its subsequent borrowings to redeem dollar-denominated debt and to defend the falling peso. This was a mistake. Defending the peso exchange rate after December enabled foreign owners to sell Mexican assets on more favorable terms, so they had an incentive to sell. A free float would have made it more costly to convert pesos to dollars and, therefore, would have reduced the flight to the dollar. Furthermore, instead of paying off the Mexican debt as it came due, Mexico should have forced renegotiation and an extension of the debt's maturity. Holders had demanded a premium for taking the risk of holding the Mexican debt. When the risk came due, the Mexican government paid off the creditors and shifted the burden to the Mexican public for the benefit of the debt holders.

Mexico's problems were not the result of a sudden mania by speculators. They were caused by the inflationary policies of the Mexican government during an election year and the continuation of these policies after the election.

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Political instability had a role, but interest rates and exchange rates were stable from April to October. Speculators bet heavily against the peso in November and December because they perceived correctly that Mexican policy was on a course to devaluation.

The policy of the Mexican government was flawed. But the U.S. government and the IMF contributed by their willingness to lend and "help" the Mexican government with loans, followed by debt restructurings and forgiveness. These offers, made in the name of humane assistance, encourage the behavior that causes the problem. For much the same reason that deposit insurance encourages weak U.S. banks and S&Ls to engage in risky behavior, international lenders encourage weak governments to take risky gambles.

The task for Mexico is to stop trying to fool investors — borrowing here and repaying there — and to concentrate on reforming its political and economic institutions to gain the confidence that is lacking.

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STOCK INDEXES

Bull still charging

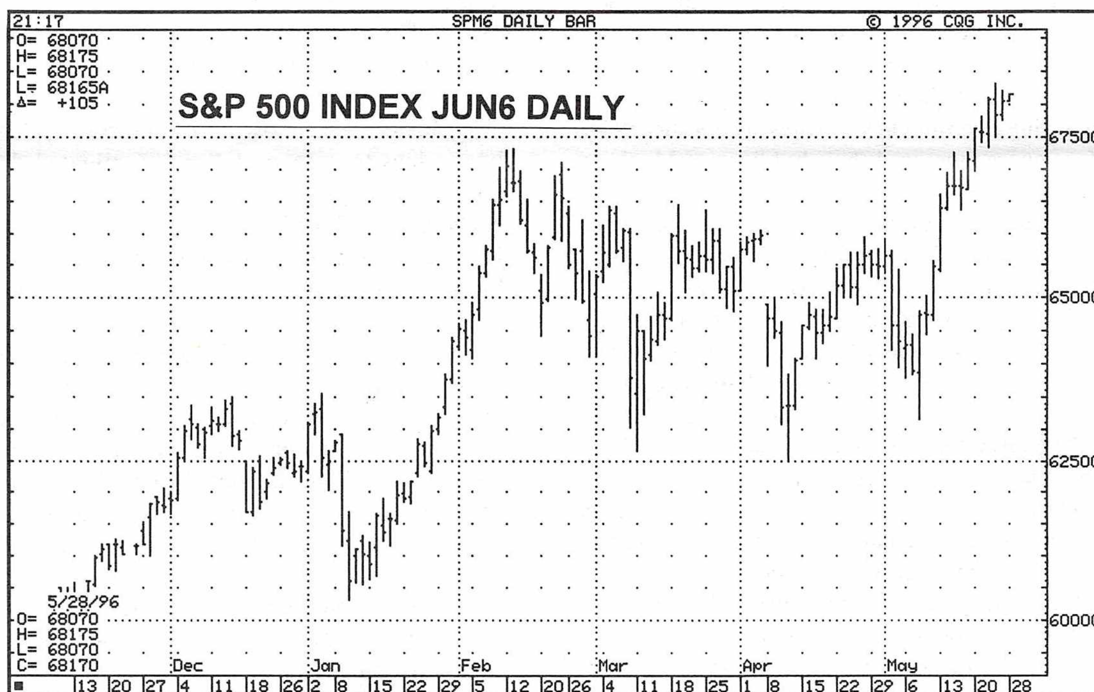
Although, as we said last month, we were conscious of the almost insurmountable odds of picking a top to one of history's most spectacular bull markets, we threw caution to the wind and advised initiating short positions on the June S&P at around 638.75. By so doing, we tried anticipating a break of the 625.00 support, penetration of which would have confirmed an end to the bull market or at the very least a sizeable intermediate decline.

This short position was stopped out at 660.00 as per the initial advice. The upside breakout of the February-May consolidation triangle augurs strongly for a new and more accelerated advance to new highs. This is supported by another surprisingly low reading in our proprietary sentiment indicator, which has had an excellent record in signalling important intermediate moves (and for which we paid dearly by ignoring it).

Speculation is on the rise, valuations are absurd, and the advance is beginning to take on the looks of a parabola, a sure sign that we are rapidly approaching a top. If indeed it is, will the bull market's tail be as dramatic as gold's blowoff in late 1979, which doubled in a three-month period?

STRATEGY: *Clients are now long June S&P at 674.50, with initial stops at 664.00 as per flash update of Monday, May 20.*

Chart 3



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GOLD

Defying the consensus

Grudgingly, the market continues to give ground with surprisingly little effect on the bullish consensus.

According to Gold Fields Mineral Services' recently issued *Gold 1996*, the gold market faces a shortfall this year unless central bank sales and high levels of producer hedging can match supply and demand.

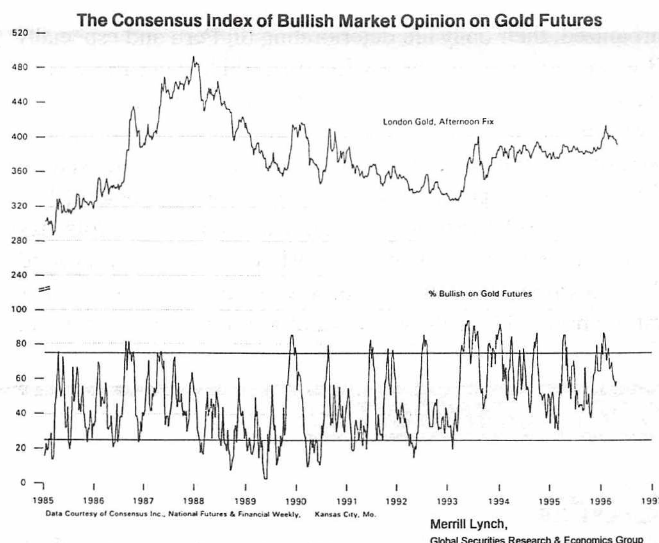
In 1995 a supply gap of 682 tonnes was filled by increased producer hedging and higher official sector sales. Output of newly mined gold edged down to 2,272 tonnes from 2,280 tonnes, largely through a 10% fall in output from a major supplier, South Africa. The record demand of 3,622 tonnes was met by net central banks sales increasing to 201 tonnes from 86 tonnes (out of which Belgium accounted for 175 tonnes in March 1995), forward sales rising to 461 tonnes from 163 tonnes, and supply from option hedging up 30 tonnes to 87 tonnes. Jewellery fabrication demand continued strong at 2,749 tonnes, 6% higher than in 1994 and just above the previous record of 1992.

It is a tribute to this market's ability to absorb supplies that forward sales last year almost equalled South Africa's production for one year. As we've stated countless times in the past, it does not require a mathematician to figure the point at which forward sales begin to lose their impact on the market. It is precisely at the point at which *total outstandings* begin to decrease. In the meantime, mine production has begun to trend down and fabrication demand gathers upward strength with each day that the price of gold falls in real terms.

Continued sluggish action should finally have an impact on the still too high consensus. Good support is indicated around the 387.50-388.00 area.

STRATEGY: *Futures traders stand aside. Option traders are long via the cheapest calls ever granted by any dealer community.*

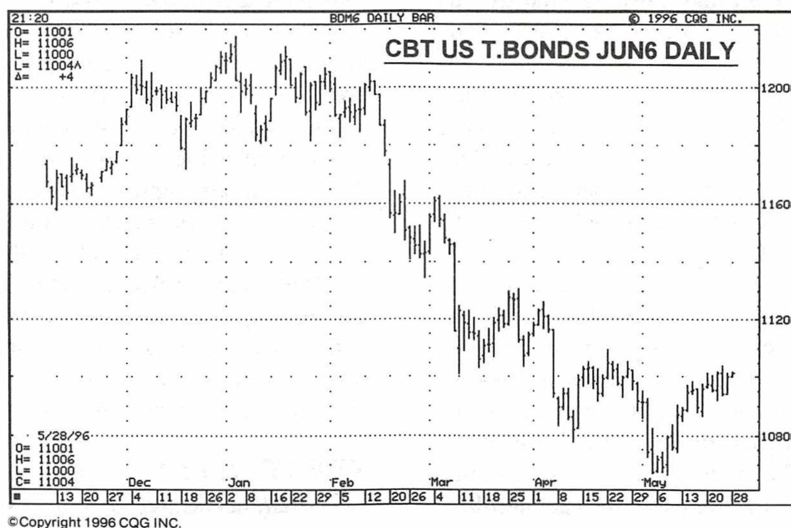
Chart 4



INTEREST RATE FUTURES

STRATEGY: *We advised adding to existing modest short positions on scaleup to 112.00. Place initial stops at 112.26, close only.*

Chart 5



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VENEZUELA

Still betting on a turnaround

Writing in *Policy Analysis* No. 251, March 25, 1996 (Cato Institute) in an article entitled "Venezuela: From Showcase to Basket Case," Roger Fontaine describes Venezuelan vulnerability to economic and social catastrophe:

"...Nowhere else in South America is there a political culture that has so thoroughly divorced reward from work and acquired a political class so loathed. Nowhere else is social mobility so restricted by a poor educational system and a regulatory maze that totally discourages entrepreneurship. In no other country have the marginalized poor been so thoroughly urbanized, their daily life deteriorating (in Peru and especially Bolivia many people, mostly Indians, still live in rural areas). Add to that a middle class that is being impoverished, a security force that is demoralized, and a tiny sector of enormously wealthy people who have done little to earn their wealth. Those are the ingredients of a societal Molotov cocktail."

The liberalization of foreign exchange controls has proceeded smoothly. The free market has stabilized around 470 bolivars to the dollar with only occasional central bank intervention. The central bank has made it clear that it will manage the foreign exchange rate with a view to "anchoring" inflation rather than for competitive objectives. In other words, one should be expecting a relatively "hard" bolivar.

Will Teodoro Petkoff, the new economic czar, have the audacity to go for a currency board? Since he has delivered on his promise to liberalize interest controls and eliminate foreign exchange controls (including controls on capital account), we will certainly not underestimate his ability to get key reforms implemented. In the meantime, the government has continued to receive congressional support for his legislative program, including the proposed increase in the VAT rate.

Also on a favorable note, one should mention that the Caldera government had never been ideologically opposed to privatization. In fact, at this point, the greatest hindrance to privatization lies in the country's lack of regulatory and administrative legislation.

STRATEGY: *With Fontaine's caveats in mind, we continue to advise an initially modest 5% exposure to Venezuelan DCBs. At 68.60, their yield to maturity just exceeds 15%.*

SOFT COMMODITIES

Corn

The corn saga started as a supply side story, with a 1995-96 US crop devastated by Murphy's Law weather. As the tale unfolded, the demand side chipped in to create the greatest grain bull market in decades. And that demand hasn't let up. Even as predictions of a return to normal crops surface, 9.375 billion bushels (238 million tonnes) against last year's 7.374 billion bushels (187 million tonnes), the December new-crop corn contract is pushing contract highs, eyeing what would have been unthinkable only weeks ago, the $4.00 level, and perhaps beyond.

Let's examine the export demand that energized this raging bull market. In the May 10 USDA report, export demand for US corn was pegged at 58.37 million tonnes. This is for the marketing year that started September 1 and ends August 31. So far, corn actually shipped totals 43.694 million tonnes. Corn contracted for, but not yet shipped, totals 14.054 million tonnes, for a grand total of 57.748 million tonnes. Can this be what the final export picture will look like?

In the 9 months since the crop year began in September, the USDA export estimate for corn has been raised 6 times by 50 million bushels (1.27 million tonnes). The obvious conclusion is that global demand far exceeded what was believable.

To project what might be in store for the rest of campaign, we might do the following: Take the average monthly increase of the USDA's revisions and spread them over the final three months. This would represent 846,000 tonnes a month, or an additional 2.54 million tonnes of demand for the year, putting the final export tally at 60.29 million tonnes. This would cause a further drawdown on stocks, changing the USDA's final ending stocks figure from 317 million bushels (8 million tonnes) to 215 million bushels (5.46 million tonnes), or 9 days' of supply! Oh, oh! And for statistics buffs, this export number would beat the record exports of the 1989-90 season of 59.85 million tonnes.

This argument, of incessant demand, supports the idea of continuing to ride the front months in this market. However, the new crop doesn't look like such a bad deal. We can be quite candid in admitting that last month we were suspicious about being long a market that had such a whopping discount built in, figuring that we couldn't possibly try to fool the market. But the market fooled us, with prices rising by as much as 30¢ a bushel, or about 10%.

Wet weather has slowed plantings to well behind normal in key growing states like Indiana, Ohio, Michigan, and Wisconsin to the extent that yields will probably be affected at least somewhat. Given the demand phenomena we are dealing with, the supply side cannot afford anything short of perfection.

STRATEGY: *The (summer) heat is (almost) on. You will need steady nerves and a deep pocket. Remain long without stops.*

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Wheat

The price of wheat has soared by 95% since early 1995. Two thirds of that gain has come in the last three months. The recent pullback amounts to a mere 13% correction of the entire bull market, and we're content to consider it a healthy consolidation. This opinion is hardly technical analysis in nature, but a reflection of fundamentals. New export sales have dried up. The first week of this month even saw a negative export number, which comes about when a previously reported sale is cancelled. These new price levels, while they create many happy farmers, also scare potential buyers. At many junctures during this bull run, similar patterns have appeared and were ultimately met by a torrent of pent-up demand, sending the market to new highs.

In addition, coinciding with the easing of export demand, comes pressure from harvest hedge selling. With these sort of prices, farmers can afford to be generous to the futures market, allowing them to lock in prices most haven't seen in their generation. This can also explain the widening of the contango between July and December. It should be pointed out, though, that the carrying charge represented in this contango is minuscule compared with other years; the tightness hasn't disappeared.

All eyes have been focused on the US winter wheat crop, ravaged by hostile weather conditions. On May 10, the USDA reported that the 1996-97 crop would yield only 1.364 billion bushels versus last year's 1.547, bringing the total US crop down to 2.074 billion bushels (57.6 million tonnes), down from 2.186 last year. While the US is by far the world's largest exporter and its crop acts, in wheat and other agricultural products, as the swing factor, an examination of other major exporters is warranted:

- **Australia:** In the April USDA world crop report, Australia's 1996-97 wheat crop was estimated at 16.62 million tonnes. In this month's report the figure was raised to 18 million tonnes, a significant development for a country that exports about 75% of its wheat production. However, the province of Western Australia, which produces about half of the country's wheat crop, is in serious need of rain. Analysts say that if they don't get any precipitation by June 6, all hope for a normal crop, the kind needed for the desperate global stock situation, will be lost. A normal crop for the region is 7 million tonnes, and there's talk of a 4 million tonne crop if the rain doesn't arrive.

- **Canada:** Spring wheat acreage was expected to rise by 14% to 13.5 million acres in the Province of Saskatchewan, producer of 60% of Canada's formidable 26 million tonne wheat crop. The acres were to be stolen from canola and other crops.

Things have changed, though. As of May 22, owing to excessive soil moisture, seeding progress in the province was a disaster. Only 8% of the crop had made it into the ground compared with the 52% average of the previous 5 years! The implication is that because of the fear of the crop lasting too long into the frost season in the autumn, farmers may be forced to switch back to earlier maturing crops, wiping out the much hoped for additional crop potential.

While the USDA reported that the 8% increase in world production to 578 million tonnes will leave us with ending stocks of 114.76 million tonnes, 3 million tonnes more than the 1995-96 season, it does not account for these 2 problems. The Canadian and Australian situations alone could drop the ending stock figure by some 5 million tonnes.

Prices have indeed wavered, but the bull lives.

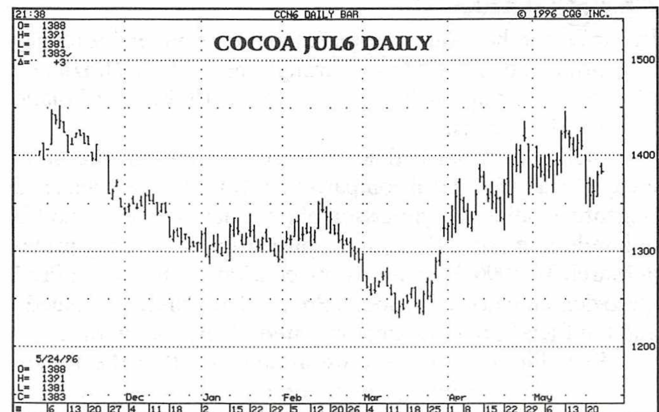
STRATEGY: *Reentered the long side as per flash update of April 30, at around 5.76, basis July 1996. Place initial stop at 5.35, close only.*

— Sholom Sanik

Cocoa

STRATEGY: *Remain long. Raise stops to 13.25, basis July, good anytime.*

Chart 10



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Coffee

STRATEGY: *Stopped out. Keep in close contact for possible reentry.*

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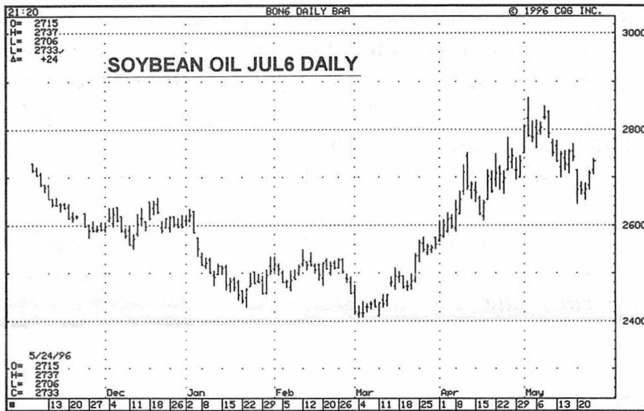
Soybean Oil

***STRATEGY:** Remain long. Maintain stops at 25.95, close only.*

Chart 8



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Soybeans

***STRATEGY:** Remain long, retaining stops at 7.50, basis November, close only.*

Chart 9

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FRIEDBERG CAPITAL MARKETS

Argentina

In our December issue we presented our argument as to why Argentine debt should trade through that of both Brazil and Mexico while approaching yields similar to those of Poland and the Philippines.

Included in our article, entitled "Argentina: the great escape," was a graphical comparison of Brazilian, Mexican and Argentine yields, a comparison of peso-denominated and US dollar-denominated debt, and a projection of security prices at March 31, 1996. Specifically, we considered the Bocon Pre 1 (peso denominated), the Bocon Pre 2 (US dollar-denominated), and the FRB (US dollar-denominated). Here's an update:

Recalling our analysis, we anticipated that the Bocon Pre 2 would be trading at 380 basis points (bps) over US Treasuries, the Bocon Pre 1 would be trading at 500 bps over Treasury, and the FRB would trade at 300 over Libor. As at May 9, 1996 (a little later than our original time frame), the Bocon Pre 1 was trading at 398 bps over US Treasury, the Bocon Pre 1 was trading at 754 bps over Treasury, and the FRB was trading at 650 bps over Libor. As you can see, the prediction was remarkably accurate for the Pre 2. However, there were significant discrepancies with the other two.

The primary reason for the discrepancies was the excess risk premium on peso-denominated debt compared with what was originally estimated. We incorporated a 120 bp spread into our previous projections; however, the spread realized between the Bocon Pre 1 and the Bocon Pre 2 was in actuality 350 bps.

As well, part of the discrepancy with the FRB would appear to be related to the benchmark used. Since the bond is priced on a spread basis over US Treasuries, and given that it is of longer duration than the Pre 2, it would follow that the FRB's spread over Treasury would have to be at least as great as that of the Pre 2. Perhaps we were not all together correct in our previous methodology. Nevertheless, we look for the spread over Treasury on the FRB to decrease to 250 bps.

We remain convinced of our previous assertions in terms of Argentina's Latin neighbours. In our previous article we discussed a number of Argentina's fundamental strengths relative to Mexico and Brazil. They included the superiority of the banking system, the higher level of domestic savings, and a healthier balance of government finances.

Ironically, there has been some question lately about Argentina's ability to meet its fiscal goals. Tax revenues have in fact come in slightly below those required to meet budget targets. These shortfalls, however, should not be of too much concern given that greater revenues are expected in June of 1996. As well, renewed economic growth will generate increased tax revenues for the government coffers. Finally, the government does reserve additional flexibility in the event of a slight shortfall of its targets. As fiscal uncertainty subsides, so too will Argentine yields.

Charts 11 and 12 compare Argentina, Mexico, and Brazil yield curves at November 9, 1995, and May 9, 1996. The charts illustrate that over this period, not only did spreads over US Treasuries decline for all three countries but more importantly, the market's perception of Argentina has become significantly more favorable.

The charts also show that currently, Argentina and Brazil are trading very similar to each other and that both trade at a slight discount to Mexico. We believe that Argentine yields will continue to move through those of Mexico and Brazil and should approach spreads over Treasuries similar to those of the Philippines (160-225 bps) and Poland (160-215 bps).

Chart 13 illustrates the tremendous change in the market's perception in terms of currency risk. The risk premium associated with convertibility was in some cases over 1,000 bps in late 1995. Currently the *average* premium has been reduced to its previous record low of approximately 300 bps.

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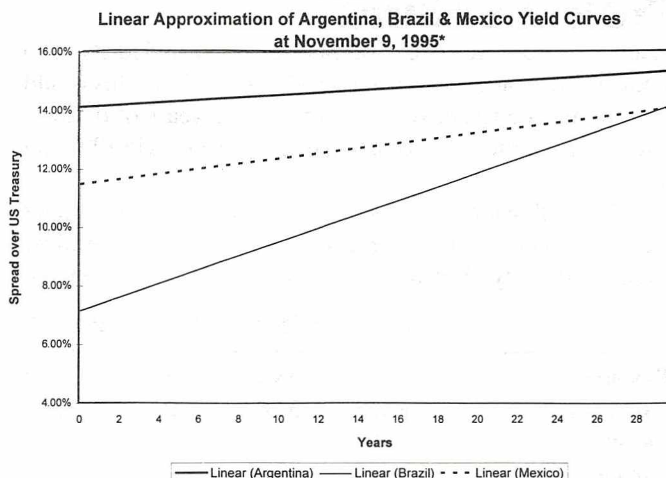
Welookforafurthernarrowingofthisspread(to150bps)as arock-solidconvertibilityregimeearnstherespectitisdue.

Chart 14 outlines our new targets for Argentine debt. We feel that during this period, Argentina will establish itself as a more progressive state and finally separate itself from its Latin neighbours in terms of the market's risk perception. Our estimates do incorporate a more favorable assessment from investors and indicate that there continues to be ample rewards for those who hold Argentine debt.

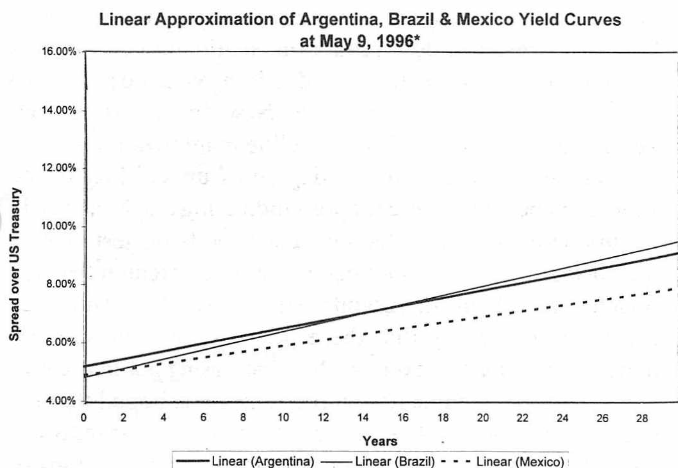
STRATEGY: *We continue to recommend Argentina as a strong hold. For additional yield pick up of approximately 150 bps, we suggest exposure to peso-denominated debt.*

Chart 11



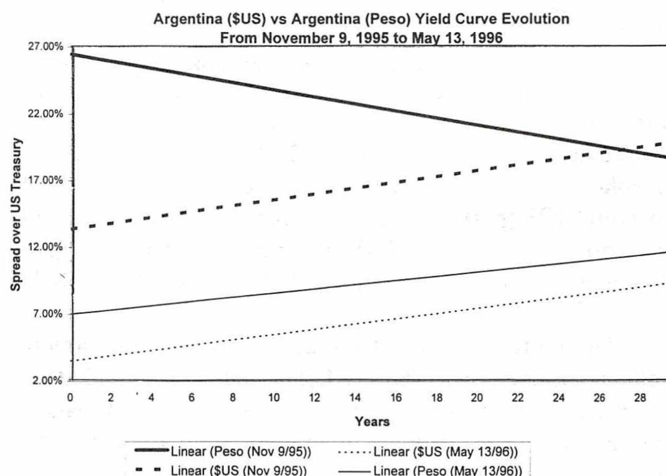
* Brazil and Mexico did not have comparable instruments within 0-5 years

Chart 12



* Brazil and Mexico did not have comparable instruments within 0-5 years

Chart 13



US$ Debt - Bocon Pre 2, Bocon Pre 4, Bocon Pro 2
AP Debt - Bocon Pre 1, Bocon Pre 3, Bocon Pro 1

Chart 14

	PRICE			Total
	13-May-96	31-Dec-96	% Change	Return
FRB	77.56	87.10	12.30%	16.44%
Bocon Pre 1	102.58	120.51	17.48%	17.48%
Bocon Pre 2	111.30	123.45	10.92%	10.92%

* Assumes constant Libor and Savings Account Rates at current levels.
** FRB @ 250 bps over Treasury, Pre 1 @ 350 bps over Treasury, Pre 2 @200 bps over Treasury.
*** The FRB currently pays interest so Total Return is greater than % Change in Price.

	YIELD		
	13-May-96	31-Dec-96	% Change
FRB	12.00%	9.30%	-22.50%
Bocon Pre 1	14.13%	10.09%	-28.59%
Bocon Pre 2	10.57%	8.59%	-18.73%

* Assumes constant Libor and Savings Account Rates at current levels.
** FRB @ 250 bps over Treasury, Pre 1 @ 350 bps over Treasury, Pre 2 @200 bps over Treasury.

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New Zealand

Recently, the government of New Zealand tabled its 1996 budget and projected a surplus of NZ$3.9 billion. This would be the third consecutive surplus following years of deficits, with the government forecasting future surpluses in 1997 and 1998 as well.

The following is the forecast New Zealand government operting balance for the next three fiscal years released by Treasury on May 23, 1996 (in billions of New Zealand dollars):

	1995/96	1996/97	1997/98	1998/99
Revenue	35.01	35.36	35.58	37.18
Expenses	31.23	32.87	32.76	32.73
Surplus	3.90	2.76	3.29	4.92
Surplus/GDP (pct)	4.40	2.90	3.30	4.70
Net worth	3.19	5.95	9.24	14.16
Net debt	28.98	27.39	24.50	20.45

Note: In its Budget Policy Statement released in February the government was forecasting:

	1995/96	1996/97	1997/98	1998/99
Revenue	35.06	35.47	36.15	37.85
Expenses	31.62	32.48	32.40	32.33
Surplus	2.97	3.32	4.21	6.02
Surplus/GDP (pct)	3.30	3.50	4.20	5.70
Net worth	2.05	5.38	9.59	15.16
Net debt	30.01	27.84	24.01	18.78

The budget contained no major surprises and largely reflected market expectations. Other highlights included average forecasted GDP growth of 3.3% over the next 3 years, a reduction in the bond tender program by approximately 30%, as well as spending commitments on infrastructure development, education, health care, and tax cuts.

The budget epitomizes the success of economic reform in New Zealand. Responsible fiscal and monetary policy combined with privatization and the adoption of a competitive mandate within government and the services it provides has enabled the country to run not only budget surpluses but to pay down debt. Projected debt to GDP is estimated at 32% for this year and forecasted at 20% for the 1998-1999 fiscal year. As a result, the budget should have positive financial market implications.

However, other factors are currently overshadowing these positive fundamentals. The tough monetary stance of the Reserve Bank of New Zealand (RBNZ) continues to influence both the bond and stock markets in the way of higher interest rates. As well, recent US bond market activity is causing domestic bond yields to rise. Finally, the bond market has recently become more sensitive to the upcoming election, thereby increasing the level of uncertainty. As a result, rising yields have contributed to both lower bond prices as well as declining stock market valuations.

We feel that while the market is reacting negatively at the moment, the current situation represents an opportunity for investors. Bond prices have recently fallen as a result of increasing domestic interest rates. Eventually rates will subside given that tight monetary conditions will succeed in lowering inflation to within the 0% to 2% band.

Fundamentals driving property prices, which is the main inflation concern of the RBNZ, have begun to show signs of a turnaround that may allow for a moderate easing of monetary policy in the second half of 1996. Other cases for higher bond prices involve a decrease in the supply of government bonds as a result of debt reduction, sentiment that perhaps bonds have been oversold, and a declining yield curve, implying lower future interest rates. The New Zealand stock market should react positively to a decline in interest rates.

There remains a greater degree of uncertainty in the short term because of recent polls indicating a tighter race in the upcoming national election. These polls suggest there is increasing support for political parties that threaten the very policies underlying the country's success. The result is an increasing possibility that these policies could be watered down as other parties exercise their increasing political clout.

Finally, as the election approaches, it is hoped that tax cuts, which incidentally are geared to lower-income individuals, will prompt the electorate to reconsider the virtues of existing economic policy.

STRATEGY: *New Zealand bonds and equities are currently experiencing price declines that we feel are relatively short-term in nature. Both the political and interest rate situation will unfold before year-end, and we believe investors will refocus their attention on the country's fundamentals at that time. Although a strong case can be made for potential upside in both financial markets and the likelihood of major policy changes remains remote, we advise that the political situation be monitored closely.*

— Peter O'Sullivan

Chart 17
Recommended current portfolio allocations

1. Queensland (Gold Bull)	15%	4. Czech Koruna	15%
2. Venezuela DCB	5%	5. New Zealand Gov. (8%)	30%
3. St. Luke CV	10%	6. PRE-1	25%

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Chart 16 — Foreign Currency Bonds

DATE: May 23, 1996 *We offer the following Bonds subject to change without prior notice: Minimum US $5000 (CDN $7000)*

ISSUER / COUPON / MATURITY DATE	PAR VALUE	BID	OFFER	YTM	CURR. COUPON	NEXT INTEREST PAYMENT DATE
DEUTSCHE MARK DENOMINATED BONDS						
World Bank 5 7/8% 4/02/97 RRSP eligible		101.05	101.90	2.97		Feb-04
World Bank 7 1/4% 13/10/99 RRSP eligible		107.50	108.35	4.51		Oct-13
World Bank 9% 13/11/00 RRSP eligible		116.50	-	-		Nov-13
Kingdom of Denmark 6 1/8% 15/04/98		103.25	104.10	3.81		Apr-15
Argentina 8% 5/10/98		102.40	-	-		Oct-05
Kgdm. of Spain (6 Mo. LIBOR-1/16) 29/6/02 (semi)		99.71	100.01	-	3.6875	Jun-28
CZECH REPUBLIC KORUNA BONDS						
General Electric Cap. Corp. 10.5% 23/10/98		100.30	101.15	9.88		Oct-23
Nordic Inves. Bk 10.625% 10/11/00		100.75	101.60	10.12		Nov-10
SWISS FRANC DENOMINATED BONDS						
General Electric Cap. Corp. 4 3/4% 2/7/98		103.20	-	-		Jul-02
General Electric Cap. Corp. 4 1/2% 17/12/99		104.90	-	-		Dec 17 1996
DANISH KRONE DENOMINATED BONDS						
Kgdm. of Denmark 9% 15/11/96		101.55	102.40	3.57		Nov-15
ECU DENOMINATED BONDS						
United Kingdom 9 1/8% 21/02/01		111.70	112.55	5.99		Feb-21
BRITISH POUND DENOMINATED BONDS						
Kdgm. of Sweden 8 3/4% 29/5/96		99.45	-	-		May-29
FRENCH FRANC DENOMINATED BONDS						
Credit Lyonnaise 9 1/2% 23/12/96		102.35	103.20	3.59		Dec-23
JAPANESE YEN DENOMINATED BONDS						
World Bank 5 3/4% 7/8/96 RRSP		100.35	101.20	-		Aug-07
CANADIAN DOLLAR DENOMINATED BONDS						
Eksportfinans 7 3/4% 5/11/97		101.75	-	-		Nov-05
Royal Bank of Canada 9 1/8% 7/1/97 RRSP eligible		101.60	102.85	4.17		Jan-07
Ontario Province 10 5/8% 15/7/98 RRSP eligible		108.30	109.55	5.72		Jul-15
SOUTH AFRICAN RAND DENOMINATED BONDS						
ESCOM 11% 1/6/08 (semi)		72.30	73.15	16.13		Jun-01
AUSTRALIAN DOLLAR DENOMINATED BONDS						
Toronto Dominion Bk. Aust. 7.25% 26/2/99 RRSP eligible		98.00	98.85	7.71		Feb-26
NEW ZEALAND DOLLAR DENOMINATED BONDS						
World Bank 12.5% 25/7/97 (semi) RRSP eligible		103.75	104.60	8.24		Jul-25
World Bank 8.25% 30/4/99 RRSP eligible		99.65	100.50	8.04		Apr-30
New Zealand Gov't 10% 15/7/97 (semi)		100.40	-	-		Jul-15
New Zealand Gov't 8% 15/7/98 (semi)		98.10	98.95	8.54		Jul-15
Fletcher Challenge 10.75% 15/12/97 (semi)		100.20	101.05	9.99		Jun-15
Fletcher Challenge 10.15% 30/11/98 (semi)		99.35	100.20	10.06		May-30
Tranz Rail Ltd. 10% 15/10/99 (semi)		99.30	100.15	9.94		Oct-15
Trans Tasman 9% 27/6/99 (semi)		86.65	87.50	14.60		Jun-27
St. Luke 8.7% 1/4/99 (semi) CV @ 1.00 p/sh		112.70	113.70	11.57		Oct-01
ARGENTINEAN PESO DENOMINATED BONDS	PAR VALUE			IRR		
Bocon Pre 1: 1/4/2001	134.1931	104.10	105.85	13.05		May-01-97
U.S. DOLLAR DENOMINATED FIXED CONV. BONDS						
Burnup & Sims 12% 15/11/00 CV@16.79 p/sh (semi)		168.5	-	-		May-15
Atari Corp. 5 1/4% 29/4/02 CV@16.31 p/sh		71.75	-	-		Apr-29
Coeur D'Alene 6% 10/6/02 CV@ 26.00 p/sh		97.25	98.75	6.25		Jun-10
U.S. DOLLAR DENOMINATED FIXED RATE BONDS						
Queensland Tres. (Gold Bull) 2% 4/3/98		93.55	95.55	-		Mar-04
World Bank 7 1/8% 27/9/99 (semi) RRSP eligible		102.45	103.30	6.01		Sep-27
Farm Credit Corp 7 3/4% 10/06/96 RRSP eligible		99.90	-	-		Jun-10
T.W.A. 12% 3/11/98 (semi)		100.90	101.75	-		N/A
U.S. DOLLAR DENOMINATED FLOATING RATE NOTES						
Kgdm. of Denmark 25/3/97 (Gold call, JY put),(semi)		91.40	-	-	7.534	Sep-25
United Kgdm. 30/9/96 3 mo.LIBID-1/8 (qtly),callable @100		99.87	100.17	-	5.2500	Jun-28
Canada Gov't 10/2/99 3 mo. LIBOR - 1/4 (qtly), callable @ 100 RRSP eligible		99.52	99.82		5.25	Aug-13
Bocon 1/4/01 (30 day LIBOR) starts paying May 1,'97	PAR: 126.3638	110.70	111.55	10.71		May-01-97
Argentina: Series L:FRB 31/3/05, 6 mo. LIBOR+13/16 (semi)	PAR: 99	76.10	77.60	11.80	6.249375	Sep-30
Venezuela: DCB: 18/12/07, 6 mo. LIBOR+7/8 (semi)		67.75	68.6	15.03	6.5625	Jun-20

GOLD (in ounces, at market prices, can also be held in your bond account) client eligibility determined at point of sale.

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HOTLINE UPDATE

Flash Update, Tuesday, April 30, 1996:
Good morning for Tuesday, April 30, 10:40 am. This is a flash update. In line with our comments of our newly released market letter, we are advising to buy July wheat at the market, presently trading at 5.76.

Tuesday, April 30, 1996:
Good afternoon for Tuesday, April 30. We have one new recommendation: Sell July copper at the market, placing stops at 121.75, close only. We repeat the flash update of 10:40 am this morning to buy July wheat at the market, then trading at 5.76.

Friday. May 3, 1996:
Good afternoon for Friday, May 3. The following is a recap of this week's recommendations: On Tuesday, April 30, we advised to buy July wheat at the market, then trading at 5.76 and to sell July copper at the market, then trading at 118.75, placing stops at 121.75, close only.

Flash Update, Monday, May 6, 1996:
Good afternoon for Monday, May 6, 1:50 pm. This is a flash update. We have two new recommendations:

- Futures traders are advised to establish short positions on the June S&P at the market, presently trading at 638.75, anticipating a break of the 625.00 support, as first suggested in our last market letter, placing initial stops at 660.00, good anytime.
- For those of you who purchased Amex HKO Index options, based upon our market letter recommendation of January 21, '96, we now advise you to liquidate these positions at the market.

Flash Update, Tuesday, May 7, 1996:
Good afternoon for Tuesday, May 7, 2:15 pm. This is a flash update. Liquidate long June crude oil at the market, presently trading at 21.10, cancelling the 19.50 stop, close only.

Tuesday, May 7, 1996:
Good afternoon for Tuesday, May 7. There are no changes or new recommendations. We repeat the flash update of 2:15 pm this afternoon to liquidate long June crude oil at the market, then trading at 21.10, cancelling the 19.50 stop, close only.

Friday, May 10, 1996:
Good afternoon for Friday, May 10. There are no changes or new recommendations. The following is a recap of this weeks recommendations:

- On Monday, May 6, via flash update we advised futures traders to establish short positions on the June S&P at the market, then trading at 638.75, anticipating a break of the 625.00 support, as first suggested in our last market letter, placing initial stops at 660.00, good anytime.
- For those of you who purchased Amex HKO Index options, based upon our market letter recommendation of January 21, we now advise you to liquidate these positions at the market.
- On Tuesday, May 7, via flash update, we advised to liquidate long June crude oil at the market, then trading at 21.10, cancelling the 19.50 stop, close only.

Tuesday, May 14, 1996:
Good afternoon for Tuesday, May 14. There are no changes or new recommendations.

Friday, May 17, 1996:
Good afternoon for Friday, May 17. There are no changes or new recommendations.

Flash Update, Monday, May 20, 1996:
Good morning for Monday, May 20, 9:45 am. This is a flash update. Liquidate S&P put options recommended in our last newsletter at the market.

- One new recommendation: Buy June S&P futures at the market, presently trading at 674.50 and place initial stops at 664.00, good anytime.

Tuesday, May 21, 1996:
Good afternoon for Tuesday, May 21. There are no changes or new recommendations. The next regularly scheduled update is Thursday, May 23.

Friday, May 24, 1996:
Good afternoon for Friday, May 24. There are no changes or new recommendations. This is a complete summary since our last market letter dated April 28, of all liquidations of open positions and new recommendations that remain outstanding.

- On Tuesday, April 30, via flash update, we advised to buy July wheat at the market, then trading at 5.76.
- On Monday, May 6, we advised those who purchased Amex HKO Index options to liquidate these positions.
- On Tuesday, May 7, via flash update, we advised to liquidate June crude oil at the market, then trading at 21.10, cancelling the 19.50 stop, close only.
- On Monday, May 20, via flash update, we advised to liquidate S&P put options at the market, and to buy June S&P at the market, then trading at 674.50, placing initial stops at 664.00, good anytime.

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