

25 YEARS

FRIEDBERG'S

COMMODITY & CURRENCY COMMENTS

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Yellow light: the waning effects of easy money

Conventional economic thinking is about to be turned on its head.

Conventional economics believes that central banks can create prosperity by making money and credit plentiful. Economic participants react to an accommodating monetary policy by pricing in a positive yield curve in the expectation that faster growth and inflation will follow. In a sort of self-fulfilling prophecy, "bullish" expectations encourage accelerated spending, and a new upswing is achieved.

A positive yield curve, then, should not only be an excellent instrument of policy but a predictor as well. Long-time readers may recall that in articles penned by Dr. Steve H. Hanke in late 1989-early 1990, we felt it necessary to discuss yield curves, because the Fed was using a neo-Wicksellian apparatus to formulate monetary policy. At that time (January 1990 issue, page 3) we said that "an analysis of yield curve should provide insights into the Fed's thinking and future policies."

Recent academic studies have tended to validate the predictive abilities of the yield curve. Arturo Estrella and Frederic S. Mishkin writing in *Current Issues in Economic and Finance* (Federal Reserve Bank of New York, June 1996) concluded that "The yield curve — specifically, the spread between the interest rates on the ten-year Treasury note and the three-month Treasury bill — is a valuable forecasting tool. It is simple to use and significantly outperforms other financial and macroeconomic indicators in predicting recessions two to six quarters ahead."

In "Predicting real growth using the yield curve" (*Economic Review*, Federal Reserve Bank of Cleveland, Quarter 1, 1996) Joseph G. Haubrich and Ann M. Dombrosky come to a similar conclusion: "The 10-year, three-month spread has substantial predictive power, and in this we confirm a variety of earlier studies. Over the past 30 years, it provides one of the best (in our sample, the best) forecasts of real growth four quarters into the future."

Interestingly, both studies intimated that the predictive properties of the yield curve have become somewhat less reliable over the past decade (just as the use of this tool became popular — proponents of rational expectations, please note!). Haubrich and Dombrosky are quite clear: "Over the past decade, it has been less successful: indeed the yield

curve was the worst forecast we examined." Estrella and Mishkin note that the forecasted probability of the 1990-1991 recession four quarters ahead was considerably lower than in previous recessions (a mere 25%).

To explain this occurrence, the authors conjecture that monetary policy played a much smaller role in the 1990-1991 recession than in the previous recessions, conceding perhaps (our conclusion) that recessions *can* be a function of real factors.

The reality is that, after some time, the elixir of easy money begins to lose its potency. An economy's real rate of growth is constrained by its productivity, which in turn is a function of savings, rational allocative decisions, technology, economic incentives (or, more properly, the absence of disincentives), and education.

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

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

By encouraging borrowing, easy money destroys savings. By mispricing money/capital (note: the Bundesbank uses the term "capital formation" for deposits of four years or more), easy money obscures rational decision-making, causing a misallocation of resources. By fostering a rate of inflation higher than it would otherwise be, easy money distorts economic incentives.

It stands to reason, then, that a prolonged period of easy money will weaken an economy. It will progressively raise its debt-to-income and debt-to-real net worth ratios. It will pump money into doubtful and even more-than-doubtful projects, such as chip factories, copper projects, paper and pulp mills, aircraft, and the former Soviet Union (FSU), to name just a very few, that more expensive capital would have discarded. Building and expansion will go to those who have the easiest accessibility to money and capital markets, operating in a casino-type atmosphere, which more often than not responds to glamour and hype rather than rational decision-making.

It is thus possible for junk bonds to be issued at spreads that do not cover the most recent default experience. It is possible for the FSU to ready a much-sought-after Eurobond issue despite the lack of any recognizable government and of heading into the largest fiscal deficit of any not-so-developed nation. It is possible for IPOs of companies with nary a dollar of earnings to raise billions of dollars. It is possible for yields of bonds of the Republic of Italy to "converge" to within 200 basis points of Bunds despite a bankrupt state, a convalescent banking system, the collapse of Olivetti (a matter of weeks?), an incipient recession, and yet another in a seemingly endless line of impossible ruling coalitions.

Consequently, it is not difficult to understand why the yield curve forecasts have become progressively less useful; it has become harder and harder to revive the moribund patient with normal dosages of easy money. Record consumer debt levels in the US can hardly be pumped up much further, especially because lenders have started to become more nervous (see Chart 1). Consumer installment debt adjusted to

include car leases and home equity loans has reached a record of nearly 30% of disposable income; and for a graphic illustration of the ratio of total consumer debt to disposable personal income (DPI) see Chart 2.

Cheaper money is unlikely to sustain accelerated capital spending in the face of overcapacity plaguing US industries (see the accompanying article reprinted from *The Wall Street Journal*), especially in view of weak profit margins (using EBITDA to remove the effect of lower corporate taxes in recent years and falling interest rates, rather than the after-tax reported earnings, as pointed out by the editor of the *Bank Credit Analyst*).

Finally, fiscal policy, both here and abroad, is tightening for a variety of reasons but principally because of the coming explosion of pension payments. The IMF has calculated a baseline scenario where general government revenues and non-pension expenditures maintain constant ratios to GDP, and pension benefits per retiree, based on the country-specific pension rule, generally rise in line with per capita nominal GDP. The results: The deficit and debt levels start to explode in the first few decades of the next century. By 2050, deficits are in excess of 20% and debts are in excess of 400% of GDP respectively!

A yellow light is flashing. Economic activity in the US is slowing. Our friends at International Strategy and Investments (ISI) have produced a yield-curve forecast based on the more recent 1982-96 period, rather than on the longer 1961-95 period covered by the Cleveland Federal Reserve study, which sees US GDP growing at 1.5% over the next 4 quarters. This modest forecast too may fail to pass the mark, given the dynamic process of debilitation underway.

Europe and Japan have resorted to easy money to revive their stagnating economies, so far with little or no success. Finally, and worryingly, Asian economies have begun to lose momentum. Industrial production in both Singapore and China is down 7.6% and 2.3% year-over-year respectively.

Is a synchronized downswing in the offing *despite* easy money?

Chart 1

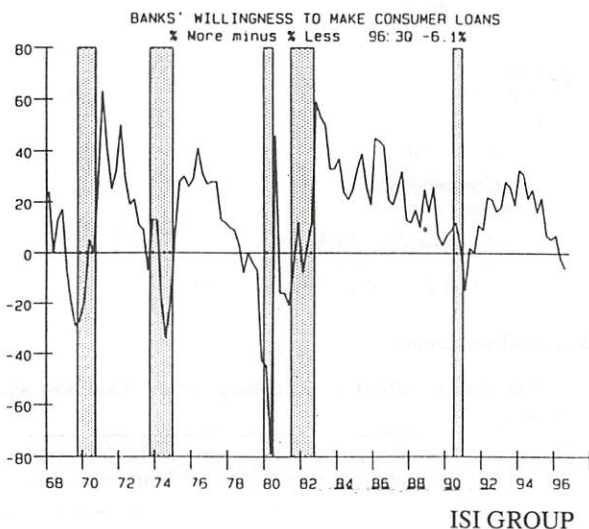
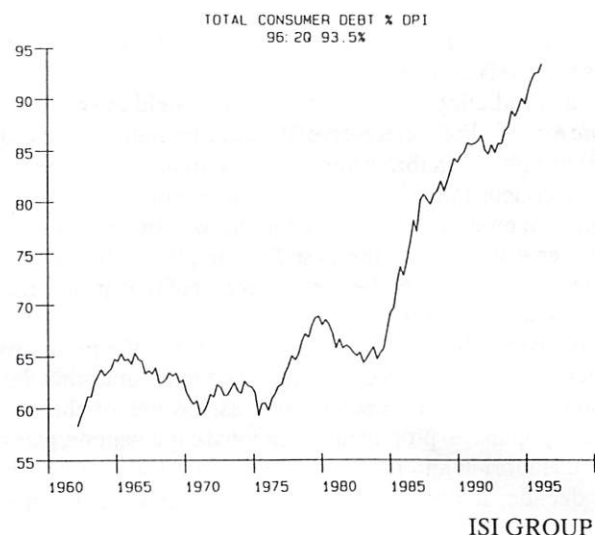


Chart 2



THE ECONOMY

Capacity boosts take toll on many firms

By Fred R. Bleakley

Staff Reporter of The Wall Street Journal

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The economy was perking along and paper prices were hitting record highs early last year as Union Camp Corp. began reaping the benefits of a grand expansion plan. Four years earlier it had installed some of the biggest, newest machines to increase its capacity by one third. The orders were rolling in.

There was only one problem: Other paper companies had the same idea. As the supply of containerboard — the basic material for packing crates — overwhelmed demand, prices plummeted to \$350 a ton from \$520.

"Everyone wanted to maximize their new investments," says Stuart Howell, Union Camp's head of strategic planning. "There were too many big dogs at the same dish." He is hoping the pricing trend will reverse with the Oct. 1 posting of a \$30-a-ton increase. But, he adds, "it's too early to tell if it will stick."

Far from unique, the supply-and-demand mismatch that has pushed down prices in the paper industry has become a problem for a number of American industries as evidence grows that companies have invested too heavily in new plant and equipment. The trend already has thrust some companies into cutthroat pricing battles to keep their own production lines running at a good clip. Others in such areas as steel and rubber are bracing for more competition from new plans due to be fired up next year and beyond.

While such pricing pressure is good news for consumers, it is likely to eat into the heady profits many companies are currently enjoying. And if the economy weakens, the capacity growth in many other industries could prompt another round of belt tightening.

"We have too many products chasing too few buyers," says James Paulsen, an economist and chief investment officer of Investors Management Group, Des Moines, Iowa. He adds the pressure to lower prices is rising in many industries because growth in total U.S. industrial capacity has risen sharply over the past two years.

Since the second quarter of 1991, the annual rate of business spending for capital equipment in the manufacturing sector jumped from \$368 billion after inflation to \$563 billion in the second quarter of this year. The Federal Reserve reported last week that the nation's factories, mines and utilities operated at 83.3% of capacity in September, down slightly from 83.4% in August and July. In late 1994, the rate topped 85%. Economists say the recent declines were due to a combination of slower production and continued buildups in capacity. Lower utilization rates are believed to hold down the inflation rate.

In the steel industry, USX's Corp.'s U.S. Steel Group is

bracing for more competition from new minimills that will go into production next year. Encouraged by the pickup in demand for steel in recent years and the recovery in prices over the past year, steel companies are planning to add 10 million tons of capacity next year, an 8% leap from present levels and the largest increase in a decade. U.S. Steel President Paul Wilhelm expects demand to remain strong next year, enough to keep a floor under present prices. But, he concedes, the question is how disciplined "the new minimill producers will be."

Not as much as the steel industry would like. Analysts expect a 3% decline in the prices of the most popular steel. "It's going to be a tough year for steel producers," one Wall Street analyst predicts.

The same is in store for the \$30 billion rubber and plastics industry. "The economy won't grow fast enough to absorb new capacity due to be added in 1997 and 1998," says Merrill Lynch & Co. analyst John Roberts. "It's unlikely that this late in the economic cycle demand will outpace capacity."

The combination of weaker sales and new additions to capacity add up to lower utilization rates and eventually more pressure to delay or forestall price increases. In the automotive sector, the motor vehicle and parts capacity utilization rate fell the most in last Thursday's government report — to 79.8% from 82% — largely due to sluggish sales.

But capacity buildup played a part too. Since late 1994, when the capacity utilization rate for the group was nearly 89%, capacity in the industry has increased four times as fast as the 3.7% rise in production. Capacity in the overall durable manufacturing category, which includes autos, appliances, furniture and other industries, is now 7% higher than a year ago — a pace not matched by demand.

To be sure, the prospect of stronger international sales, especially from the developing countries of the world, has spurred much of the capacity additions by U.S. industry. In computers and semiconductors, the prospect of millions of middle-class consumers in the developing world eagerly embracing technology in coming years has many industry officials believing many more plants than now on the drawing boards will be needed.

Although Texas Instruments Inc. is one company that suffered from a rapid buildup in semiconductor capacity in 1996, the company sees that capacity being rapidly absorbed by customer demand. Vladi Catto, chief economist of Texas Instruments, figures demand for semiconductor chips will grow at a 20% clip over the next few years and that within 10

years the developing world will be spending more money on them annually than current world-wide sales of \$150 billion.

Overcapacity can lead to downward price spirals within industry and product groups. However, it can be "good news for inflation," says Gail Fosler, chief economist of the Conference Board, a nonprofit business research group, in New York. She thinks the excess is unlikely to get out of hand, yet notes that the excess capacity that does exist tends to keep prices in check.

Even so, there is a ripple effect to overcapacity that has some capital-equipment suppliers worried. Unless they are part of the buildup, truck, forklift and machinery suppliers may see orders slow as they customers grapple with how to

make full use of what they already have on hand. "My clients in heavy manufacturing hope they can keep prices constant next year; they're worried about deflation," says Kurt Karl, head of the U.S. forecasting for Wefa Group, an Eddystone, Pa., economic consulting firm.

Mr. Paulsen, the economist, says his industrial clients share those concerns. He adds that the reason inflation didn't climb in recent years, as is customary during economic expansions, was due to slower-than-average sales growth and above-average capacity growth. Now, with added capacity coming on stream, his prediction is that overall inflation will decline more than usual during the next sharp economic slowdown or recession.

NEW ZEALAND

Staying the course

The inconclusive electoral results in the recent election begins what is probably a long period of political paralysis at best and bad government at worst. In the best case, a National-Act minority government will coast along until the economy reaccelerates and inflation falls decisively below 2% per annum. It will then try to pass the second stage of its tax-cutting program. If the government is voted down, it will probably call a new election.

This minority government will do little else of any significance, given the formidable array of left-wing and nationalist opponents it faces in parliament. With all, a do-nothing government will be a good thing, as it will consolidate the extraordinary achievements of the past dozen years. Inflation will recede, interest rates will recede, the exchange rate is likely to follow a path closer to the one presently assumed by the Reserve Bank (a 1.7% yearly appreciation in the trade-weighted dollar), and the stock market will enter a new bull market phase.

The next best scenario, a National-Act-New Zealand First majority-forming coalition will need to do some foolish things to co-opt the last named, nationalist party. These could include widening the Reserve Bank inflation band to minus 1%/plus 3% from the present 0-2%; restricting foreign ownership in some sectors of the economy; some increase in government-funded housing — none of which will seriously derail the present model economy.

As a *quid pro quo*, the government will be quite certain to pass the next stage of tax cuts, and Act, the libertarian party may get a chance to propose significant changes in superannuation and education. Some economic folly will be

traded off in this case against political certainty. And the outcome might, as far as markets are concerned, be as favorable as in our first scenario — provided that New Zealand First's Peters does not misbehave and renege on handshake deals. That is a very big if.

The third and most negative scenario is a labour-led majority coalition with the socialist party, Alliance, and the nationalists of New Zealand First. This government could be highly damaging to the New Zealand economy, because it would probably try to dismantle the gains achieved in labor deregulation and uniform taxation, and to dilute the Reserve Bank's single-minded mandate to maintain purchasing power. All this plus, of course, sharply higher government spending, and curbs on foreign investors. Interest rates are likely to spike sharply higher as the Reserve Bank leans against heavy government spending and the progressive loss of foreign investor confidence. The New Zealand dollar may at the very outset spike higher, underpinned by rising interest rates.

After one to two years, investments will be affected. The coalition, however, will not have enough time, given the short three-year electoral cycle, nor enough individual members in parliament (who will vote with their conscience and against their party) to produce permanent damage.

STRATEGY: *We remain, at least for now, relatively comfortable being long the currency, bonds, and stocks of New Zealand. In fact, in our capital market section we review and strongly recommend the convertible bond issue of Kiwi Income Property Trust, truly an all-weather investment situation.*

JAPANESE YEN

Economic revival not in sight: stay short

The Japanese penchant for hiding problems and pushing off their day of reckoning threatens to worsen the banking industry's condition and continues to hamper economic recovery. This past Tuesday, Nichiei Finance filed for liquidation, with massive debt liabilities of more than \$8.8 billion, spurring worries about the health of other finance companies and banks.

According to Teykoku Data Bank Limited, a research institute that specializes in bankruptcy data, the Nichiei filing is the largest insolvency case in the post-war period.

The banking system is being kept afloat by a number of accounting forbearance schemes. One is to provide a bridge loan just before the end of an accounting period. Another is to flip loans back and forth between paper companies every six months to make it look like loans had been paid back and replaced by new ones. A third is to create a subsidiary in which to hide all the problems. The accounts of such subsidiaries do not usually appear in the unconsolidated accounts of Japanese financial institutions.

According to the research institute, if Japanese banks were to fully disclose the state of their finances, their capital-to-assets ratios would fall to 2%-3%, well down from the minimum 8% required by the Bank for International Settlements.

Clearly, a renewed economic downturn could cause a severe financial crisis, leading to bank runs and tipping the economy into a depression. On this score it should be noted that the economy may have contracted in the July-September quarter after the negative April-June quarter. This would technically put Japan into a recession.

To avoid a depression, the Japanese government must force the banking system to liquidate its bad debts, thus helping to set market-clearing levels in the property market. As well, it must introduce realistic reporting standards for the banking systems, eliminating all forms of accounting forbearance, to regain much-needed confidence. On the fiscal front, it must give up attempts to pump-prime the economy via spending increases and concentrate instead on significant tax cuts. Finally, it must allow the yen to continue falling to reverse the fall in the trade surplus and thus contribute to the economic recovery.

STRATEGY: *Only a revival in economic activity can turn the falling yen; we're still some way off. Remain short yen against long position in New Zealand dollars and more recently Sterling.*

Chart 3

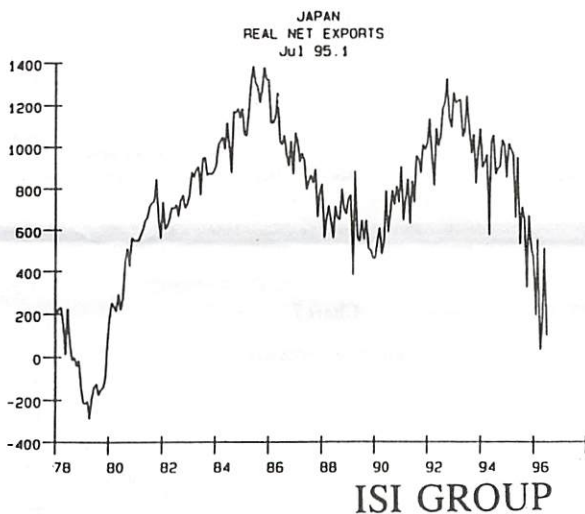
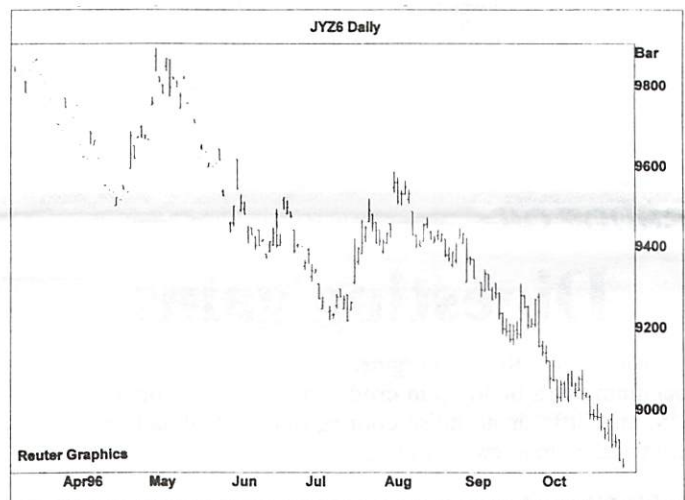


Chart 4
Japanese Yen - Dec. 1996



CANADIAN DOLLAR

Waiting for rates to bottom out

A number of factors coincided to focus the attention of global currency traders on the Canadian dollar: A substantial improvement in government finances, with the deficit moving down to an estimated 2.6% of GDP in 1996 and 2% in 1997 from 5.9% peak in May 1993, a monthly trade balance averaging well over \$3 billion per month, a reversal of the current account balance from a deficit to a small balance, and a real undervaluation of the currency on a purchasing power parity basis.

The Bank of Canada has used the opportunity to lower interest rate differentials *vis à vis* the US, which has moved from 250 basis points above the US to more than 160 basis points below US. A relatively stable exchange rate and falling interest rates have produced a sharp decline in the monetary condition index (see Chart 5). The index is at a new low since the first

quarter of 1995. The growth of monetary aggregates remains moderate with M1 at +9% year-over-year and M2 at +3.9%.

The Bank of Canada has indicated that the low rate of inflation being experienced will allow a 1.5% per annum currency appreciation without unduly affecting the competitiveness of the economy. This modest exchange rate expectation explains the Bank's aggressive interest rate policy; despite new lows in the monetary conditions index, the Bank has insisted on leading interest rates lower. Negative interest rate differentials will sooner or later place a cap on the exchange rate. The inevitable adjustment, i.e., a revaluation of the currency, will then come via higher rates of inflation.

STRATEGY: Stand aside until a bottom in interest rates is at hand.

Chart 5

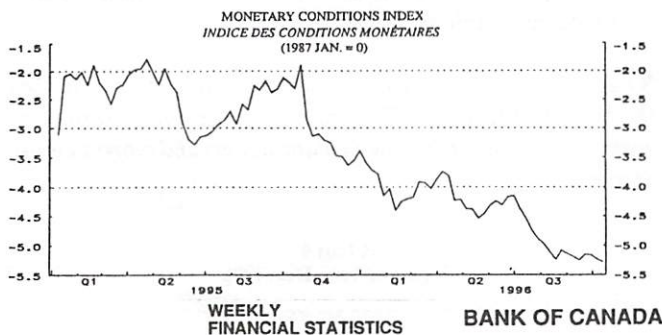
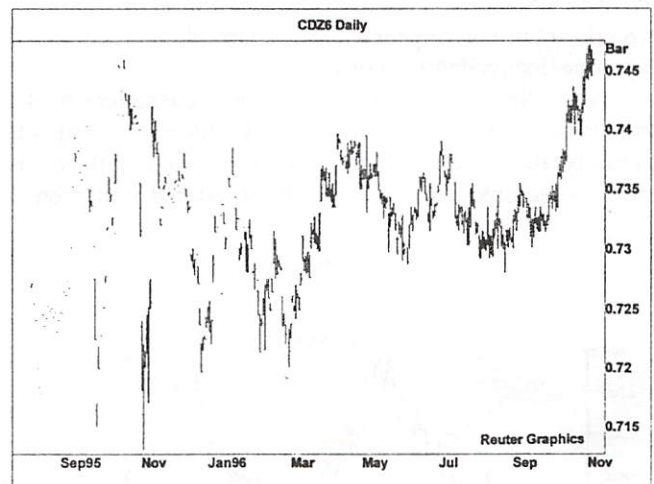


Chart 6 – Canadian Dollar - Dec. 1996



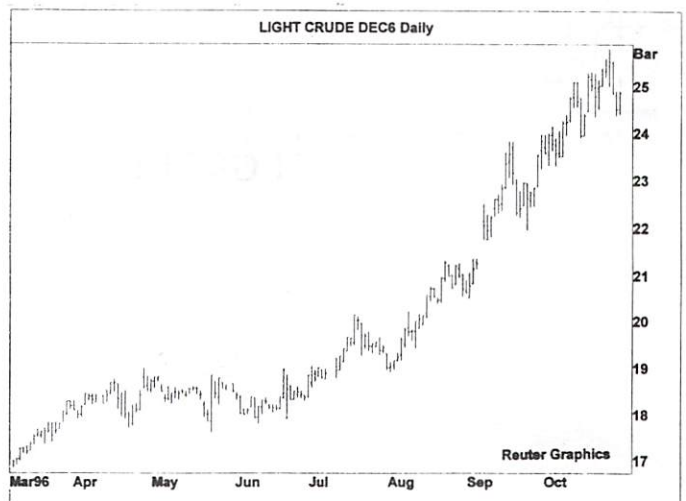
CRUDE OIL

Digesting gains

Deteriorating refining margins, slightly warmer weather, the beginning of a build-up in crude and distillate stocks in the US, and little or no noise coming out of Baghdad have all contributed to a few bouts of profit-taking.

STRATEGY: We have advised liquidating long positions and nailing down some substantial profits. While the fundamentals remain bullish, we believe that the market needs some time to digest the spectacular gains of recent months.

Chart 7



GOLD

Down, then up

Renewed activity in the gold loan market — and thus forward selling — is detectable in rising leasing rates. This explains the market's inability to rally strongly from recent lows after the IMF deferred its plans to sell up to 5 million ounces.

Market sentiment remains too bullish for a futures contract that has declined more than \$47/ounce (see Chart 8). Option writers, however, are still betting that the 380-410 range will persist for quite some time. Betting against tunnel-vision option writers, who have knocked volatilities to unthinkably low levels, we believe that prices will first pierce support — the shakeout should be sharp and brief — and later handily vault through the upper part of the range.

STRATEGY: For the very near term, trade futures from the short side with stops around 385, basis spot, good anytime. Investors should remain long via long-term call options.

Chart 8 — Gold - Dec. 1996

**SOFT COMMODITIES**

Corn

The market saw it coming. Back on July 12, it was a Friday, another week ended with yet another record high recorded for corn prices. December futures closed at \$3.835 with an eye on the cosmic July contract, which was orbiting at over \$5.50 a bushel. Alas, for the bulls, that day marked the end of the run. Smart farmers and savvy speculators should have been shorting the gravity out of this market.

It was a bull market that had everything going for it: low supplies and runaway demand. The basics of economics, however, then took over. Demand and prices of this ilk brought a torrent of supply. The supply came not only from corn, but from all the alternate feed grains as well. Sorghum production in the US, for example, increased by 73% over last year from 460 million bushels to 797 million bushels. This may seem of little consequence in light of a corn crop measured in billions of bushels, but consider that the difference between bull and bear markets in corn is the size of the carryover measured in hundreds of millions of bushels. A jump of this magnitude in even a minor crop like sorghum could make all the difference.

As well, a record global wheat crop will allow for lower grades of wheat to be used for feed. In Canada, where a return to bountiful crops will yield a 29.5 million tonne crop, it is estimated that in Alberta, the second largest producer amongst provinces, 62% of the crop will be of the two lowest Canadian gradings versus a 10-year average of 46% for the same statistic. The actual feedgrain quality category for Canadian wheat could contain as much as five million tonnes according to Bill Gary of *Price Perceptions* (October 19).

And then there is corn itself. The October 11 USDA crop report raised the US crop estimate to 9.012 billion bushels, a 22% increase over last year's crop. Of course, it was well known for some time that production would return to normal after last year's disastrous crop. A combination of revisions of last month's report, though, raised the ending stocks estimate by 235 million bushels to 903 million bushels. It is a bit early to judge any of the categories that were revised very fairly. If, however, the USDA is anywhere close, a 903 million bushel carryover will mark the end of the bull market as we knew it, certainly in terms of the kind of prices that were achieved by the July contract.

In studying the demand components, it is interesting to note that even with the knowledge of the availability of alternate feedgrains contained in the very same report, the USDA raised its domestic consumption figures by 90 million bushels — albeit modest, but a gain nonetheless.

This was countered by a drop in the export forecast of 100 million bushels.

Sliding prices have thus far failed to attract the kind of export demand attention the soy complex has received (see our discussion of the soy complex). If recent USDA weekly export numbers are any indication, the USDA is, at the very least, moving in the right direction in its estimate.

This past week saw a most paltry new sales figure of 220,200 tonnes of US corn sold. If the trend of weak exports continues, the USDA's annual exports estimate will begin to look quite astute. Nevertheless, as we've stated in the past, we believe the new pockets of demand that we witnessed in the past year will reappear, although at a more modest rate, given

the availability of other carbohydrate feedgrain substitutes, and prices that are by historical standards still relatively high.

Markets have a habit of testing points they originally broke out from, the \$3 area certainly qualifying as that point. The commitment of traders data show that commercials have been amassing large long positions, further evidence that we may be setting a bear trap. In itself, though, the commitment data cannot be relied upon exclusively, as the commercials have been getting long all the way down from the top. Entering the long side of this market, which we still believe can turn around on the emergence of export demand, should take all of the above into account in conjunction with sentiment and open interest readings.

STRATEGY: *Stand aside until further notice.*

Soy complex

The promise of beans-in-the-teens. Is it gone? From the supply side it doesn't look too good. The demand side, however, tells a different story.

On October 11 the USDA released its crop estimates showing a US soybean crop that will rise almost 8% over last year. Although the planting intentions told us much earlier that the crop will have improved from last year, the figure was considered very robust. The forecast was 2.5% above the average trade estimate and 26 million bushels *above the highest* trade estimate. The market was indeed surprised, as the price of January beans has fallen almost 50¢ since the report, before stabilizing last week on exciting export news.

The crop estimates of the other two key players in the soybean export game, Brazil and Argentina, retain the same healthy look as last month. One fly in the ointment, though, is that heavy rains have reportedly delayed the start of planting of soybeans in one key region. The region typically has 15% of the crop planted by the end of October. It is quite early for Brazilian plantings, but at the time of publication of this letter, the weather was still wet. So although there is no panic, it is a situation that merits monitoring.

As we've maintained all along, the export picture remains bright. The USDA raised its prediction for 1996-97 exports by 35 million bushels over last month's estimate to 850 million bushels, which would be another record-breaking year. In addition the USDA confirmed that last year's exports were a record by actually raising the figure by 5 million bushels to 845 million bushels.

These estimates have been no idle guessing game. The first few weeks of the marketing year (September-June) have shown the stuff of record-breaking years. As soon as prices gave way for a meaningful dip, we saw some of the biggest weekly export tallies on record. The fun started in the week ended October 10 with 1.163 million tonnes of new sales. It was a huge number and well above the average for beans. As if that wasn't enough, the week ended October 17 rang up 1.394 million tonnes of new sales, which was 81% above the

4-week average and just shy of the record weekly exports of 1.484 million tonnes set back in November of 1987. Just by the way, the market was then trading at \$5.50 a bushel and was on the way to \$11 a bushel by the following summer.

The exports couldn't possibly continue at this pace. However, the numbers were so large that some conclusions could rightfully be drawn. The pent-up demand is out there and will appear every time the price opportunity presents itself. The strong presence of the Chinese, who purchased 287,800 tonnes of last week's total, is a welcome sight and dispels any notion that they are well supplied.

The rising ending stocks figure, as has been well noted by many analysts, is the result of an increase in supply, not a drop in demand. Every demand category, domestic consumption and exports, is either up or the same as last year. While 195 million bushels is not the dangerous level we believed we would be dealing with at this point, it is still low by historical standards.

This market may have taken a tumble, but the spreads remain tight. The contango in the beans has been narrowing all through the drop and the backwardation in the meal is growing. The December/July meal spread made a new high at week's end of \$10.60 a ton. Thus, if we were to become longs once again, we would continue to look to the meal as the vehicle of choice.

The building of a base would arouse interest.

STRATEGY: *Nibble at the long side of March '97 soy meal. Place stops at 214.00, close only.*

— Sholom Sanik

Chart 9
Soymeal — Dec. 1996



FRIEDBERG CAPITAL MARKETS

Kiwi Income Property Trust (KIP)

Security: Kiwi Income Property Trust (KIP)*
 Convertible Notes
Exchange: New Zealand Stock Exchange
Coupon: 9%
Offer Price: \$1.10 (all figures in New Zealand dollars)
Minimum Yield: 10.64%
Redemption Value: 1.25
Maturity: Sept. 30, 2003

KIP is a publicly traded New Zealand property trust with assets of \$387 million and exposure to all three major property sectors (commercial, retail, and industrial). It is the trust's fundamental long-term objective to maximize the return to unitholders through the acquisition of a diversified portfolio of prime investment property. The criteria for investment property are as follows: (a) a secure and sustainable cash flow; (b) the potential for superior growth; (c) value added potential. Once these criteria are fulfilled, the approach of management is actively to manage its portfolio and continually to seek to capitalize on trends and opportunities.

On Nov. 6, 1996, two resolutions will be put to unitholders of the trust as a result of a proposed transaction that would see KIP purchase 5 office buildings; three in Auckland; one in Wellington; and one in Christchurch. The portfolio was sold by Sentry Investments Limited and would increase KIP's assets from \$387 million to \$512 million¹. The total value of the transaction is \$130 million and would be financed by convertible notes (73%), a renounceable rights issue (23%), and term debt (4%). The proposed transaction would satisfy a main objective of the trust; "to acquire more prime central business district (CBD) commercial property, particularly in Auckland." Portfolio sector exposure, geographical breakdown, and lease expiry profile, before and after the purchase, are found in Chart 10.

Commercial sector

The late 1980s produced a glut of commercial office space in New Zealand as evidenced by a peak vacancy rate of over 30%. Since that time, approximately 60% of this overhang has been absorbed. The vacancy rate for Auckland CBD space declined 5.1 percentage points over the last 12 months (from June '95 to June '96) and remains at 12.2%. This decline has translated into higher effective rents as landlords are now having to offer less incentives to prospective tenants. It is expected that vacancies will continue to decline and are forecasted to reach 5.1% for the entire Auckland CBD sector by the year 2000². This decline will put further upward pressure on effective rents, building incomes, and portfolio values.

Solid economic and demographic fundamentals will ensure continued rising demand for and absorption of quality space. An increase in the supply of office space is not expected to

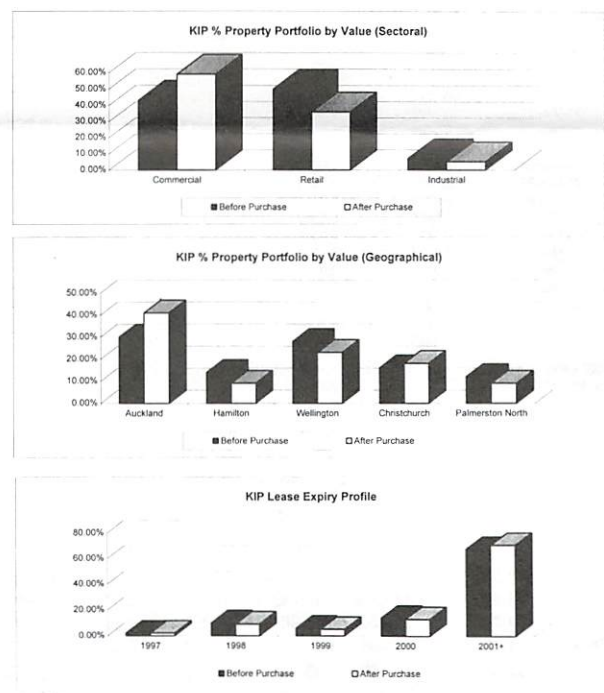
materialize for some time, as rental rates have not yet reached the threshold necessary for new projects to be profitable. (They are currently running at approximately 50% of required rates). As well, the current high interest rate environment is a deterrent to new construction, given its effect on construction financing costs. Thus, it is forecasted that significant increases in new office space will not be apparent before the years 1999-2000. Given the strong supply and demand fundamentals, this sector is expected to experience strong growth.

In Wellington, vacancy rates in the CBD sector have dipped below 10% and effective rents are increasing, albeit at a slower pace than Auckland. Vacancy rates are expected to fall to 5.9% by the year 2000, at which time a new construction phase is expected to begin. During this time, the continued absorption of space will put continued upward pressure on rental rates.

9% convertible notes

The trust will be offering \$95 million of convertible notes as part of the financing for the proposed acquisition of the above-mentioned properties. The notes, which will be issued at par \$1.10, carry a coupon of 9%, have a maturity of 7 years, and are subordinate obligations of the trust. Upon maturity, the notes are mandatorily converted to units of the trust such that the minimum value received will be \$1.25. In other words, if the trust's unit price is below \$1.25, then each noteholder will receive enough units to make up the redemption value of \$1.25. If the trust's unit price is above \$1.25, then the noteholder will receive one unit only. In addition, investors will have an opportunity to convert their notes from the third

Chart 10



*The manager of KIP is an affiliate of FCMI Financial Corp.
¹The asset value will increase to \$551 million when the purchase of Bell South Centre settles.
²Forecasts for Auckland and Wellington provided by JWL Research, New Zealand.

year after issue and every year after that (on the anniversary date) up to mandatory conversion at maturity. The guaranteed floor redemption value will not be considered except on mandatory conversion. The notes will be listed on the New Zealand stock exchange.

The convertible notes are in effect a combination of straight debt and a call option³ on the trust's units. Therefore, their valuation will incorporate the value of a discounted cash flow stream and the value of a call option. Chart 11 provides the relevant calculations. The option value is relatively small in this case since the dividend yield is high due to the nature of the trust.

For the cash flows, we have estimated that a conservative spread over NZ government bonds would be 200 basis points (bps), given the asset quality of the trust and its low debt ratio of 20% (much below the limit imposed on the trust of 35%). At this spread, the note has a value of \$1.21. Working backwards, the note is providing a yield of 11.2% (including the option value) at the offer price of \$1.10, representing a spread of 389 bps over government bonds. Therefore, we believe a price of \$1.10 represents a discount to the true value of these notes and an attractive investment opportunity.

The structure of these notes provide a minimum yield to maturity of 10.64% (without option value) with an opportunity to participate in the growth of the trust that would result from an appreciation of the portfolio's value. Chart 12 shows the attainable yields, given a combination of trust unit values at conversion and number of years to exercising of the conversion privilege. We feel the notes provide superb upside potential given management's long term growth objectives.

Class B units

A 1-for-5 renounceable rights issue for class B units is also proposed as part of the financing for the transaction. The rights will entitle the holder to purchase these units for 60¢. These new units will have all the rights and obligations of a

regular unit except that they will not receive a dividend for a period of five years. This provision is in place to preserve the dividend stream to regular unit holders over the period. Chart 13 provides the theoretical value of the new units as the value of an ordinary unit less the present value of the foregone dividend stream. Our analysis suggests that the new units are being offered at a significant discount and would imply a right value of approximately 11¢ during the trading period.

Preliminary forecasts⁴ on the impact of the proposed transaction suggest that initially the undertaking will decrease the return on equity. However, taking fundamentals and rental forecasts into consideration, the prospect for superior growth in the medium to long term is good. Over this period, financing costs will be held constant, providing shareholders with an increasing residual over fixed financing costs. Thus, increasing rental revenues over time will make the acquisition value enhancing.

KIP management has been proactive in modifying its portfolio to capture the potential growth this sector offers. We believe that the convertible notes represent a considerable opportunity to capitalize on this initiative. The management of the trust have a great deal of experience in this sector and possess all the qualifications and expertise to realize on the trust's long-term objectives.

STRATEGY: *The convertible notes offer an attractive yield and are priced at a discount to fair value. The convertibility feature will allow investors the opportunity to capitalize on both the quality of management and sector fundamentals, while the minimum redemption value will provide adequate downside protection. For these reasons, we recommend the Kiwi Income Properties 9% convertible notes. As well, we recommend that investors capitalize on equity rights trading at a discount to our theoretical value.*

³The call option component was valued using a Black-Scholes option pricing model using a long term volatility for the underlying of 20%, a 7-year government rate of 7.32% for the risk free rate, a stock price of 1.06, and a strike price of 1.25.

⁴Referring to a research brief put out by Garlick and Co. Ltd. on October 3, 1996

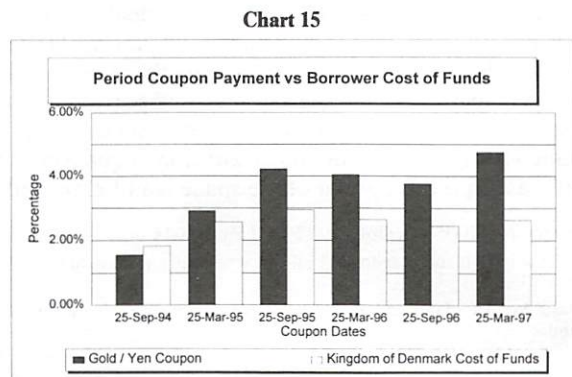
NZ Govt (7 Year)	7.3200%
Spread	2.0000% 200 bps
Yield to Maturity	9.3200%
	<i>Interest</i>
31-Mar-97	0.0495
30-Sep-97	0.0495
31-Mar-98	0.0495
30-Sep-98	0.0495
31-Mar-99	0.0495
30-Sep-99	0.0495
31-Mar-00	0.0495
30-Sep-00	0.0495
31-Mar-01	0.0495
30-Sep-01	0.0495
31-Mar-02	0.0495
30-Sep-02	0.0495
31-Mar-03	0.0495
30-Sep-03	1.2995
Straight Value	1.1615
Option Value	0.0460
Price of Note	1.2075

Current Price	1.0600
P.V. of Dividends	0.3517
Class B Price	0.7083

Chart 12 — Payoff Matrix

Price	Years to Conversion				
	3	4	5	6	7
\$1.25	13.28%	12.11%	11.42%	10.96%	10.64%
\$1.40	17.07%	14.79%	13.46%	12.58%	11.96%
\$1.60	21.75%	18.08%	15.95%	14.56%	13.58%
\$1.80	26.08%	21.11%	18.24%	16.37%	15.06%
\$2.00	30.12%	23.91%	20.35%	18.04%	16.43%
\$2.20	33.91%	26.52%	22.31%	19.59%	17.69%
\$2.40	37.49%	28.97%	24.14%	21.04%	18.87%

Yen Value at Time of Issue	¥/\$US	106.00
Current Yen Value	¥/\$US	111.39
Total Return on Yen		5.08%
Annual Return on Yen		1.94%
Excess Annual Return from Coupon (over funding cost of Libor - 55bp)		1.64%
Net (Loss) Gain from Yen Position		3.57%
Previous Net (Loss) Gain from Yen Position		1.57%



Update on Gold Bull/Yen Bear Note

On Sept. 25, 1996, the coupon for the Kingdom of Denmark Gold Bull/Yen Bear note was reset at 9.51%. As you will recall, this coupon is a function of the funding rate for the Kingdom of Denmark (6M Libor less 55 bps) and a component designed to offset an appreciation in the yen (2 times the difference between USD and ¥5 year swap rates less 5.10%), which would reduce the redemption value of the note.

Over the last period, the increase in coupon was due to the widening of the swap spread by 80 bps. A widening of the spreads would indicate that the gap between inflation expectations has also widened. This in turn would imply an appreciation of the yen relative to the US dollar. During the same period, however, the yen has depreciated in nominal terms by 3.85%. The inconsistency is the result of the deflation that Japan is currently experiencing, causing the yen to depreciate in nominal terms yet appreciate in real terms. Thus, a widening of the swap spreads is consistent with a real appreciation of the yen. The redemption value of the note, however, is linked to the nominal value of the yen, and in this case has provided additional upside to investors.

Investors are getting the best of both worlds, since the expected redemption value is helped by a weaker yen in nominal terms, and the coupon is boosted by a stronger yen in real terms. Over the last coupon period, this has increased the return from the note by increasing the downside protection incorporated in the coupon and increasing the expected redemption value as a result of the nominal depreciation.

Chart 14 shows the annualized return on the yen position up to the last reset date. It also compares this return with that calculated up to the previous coupon date in March of 1996. The hedge component has provided an additional 1.64% annually. This amount would serve to reduce a loss on a yen appreciation; however, over the period we have a positive return, given the nominal depreciation of the yen. Chart 15 presents graphically the excess coupon received over an above the cost of funding of the issuer.

The final component of this note is the price of gold. The redemption value is positively related to an appreciation in the price of gold. After experiencing a strong surge in late 1995/early 1996, the price of gold has declined back to the \$380/oz. level. Over the term of this note, the price of gold has been flat and thus has not had a great impact on the expected redemption value.

— Peter O'Sullivan

Chart 17

Recommended current portfolio allocations

1. Cash (awaiting KIPT issue)	20%
2. PRE-1	25%
3. Trans Tasman 9% (NZ\$)	15%
4. New Zealand Gov. (8%)	20%
5. Gold Bull/Yen Bear	15%
6. Sports & Recreation	5%

HOTLINE UPDATE

Friday, September 27, 1996:

Good afternoon for Friday, September 27. We have one new recommendation: Buy November heating oil at the market.

Friday, October 4, 1996:

Good afternoon for Friday, October 4. There are no changes or new recommendations.

Tuesday, October 1, 1996:

Good afternoon for Tuesday, October 1. There are no changes or new recommendations.

Friday, October 4, 1996:

Good afternoon for Friday, October 4. There are no changes or new recommendations.

Tuesday, October 8, 1996:

Good afternoon for Tuesday, October 8. There are no changes or new recommendations.

Friday, October 11, 1996:

Good afternoon for Friday, October 11. There are no changes or new recommendations.

Tuesday, October 14, 1996:

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

Friday, October 18, 1996:

Good afternoon for Friday, October 18. There are no changes or new recommendations.

Tuesday, October 22, 1996:

Good afternoon for Tuesday, October 22. There are no changes or new recommendations.

Flash Update, Thursday, October 24, 1996:

Good afternoon for Thursday, October 24, 2:20 pm. This is a flash update. Liquidate long December crude oil positions at the market, presently trading at 24.70, and November heating oil at .7070.

Friday, October 25, 1996:

Good afternoon for Friday, October 25. This is a complete summary since our last market letter dated September 25, of all liquidations of open positions and new recommendations that remain outstanding.

- On Thursday, October 24, via flash update, we advised to liquidate long December crude oil positions at the market, then trading at 24.70 and November heating oil at .7070.

Chart 16 — Foreign Currency Bonds

DATE: October 25, 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	NEXT INTEREST COUPON	PAYMENT DATE
DEUTSCHE MARK DENOMINATED BONDS						
World Bank 5 7/8% 4/02/97 RRSP eligible	100.00	-	-			Feb-04
World Bank 7-1/4% 13/10/99 RRSP eligible	108.25	109.10	3.92			Oct-13
World Bank 9% 13/11/00 RRSP eligible	115.80	-	-			Nov-13
Kingdom of Denmark 6 1/8% 15/04/98	102.90	-	-			Apr-15
Argentina 8% 5/10/98	103.05	-	-			Oct-05
Kgdm. of Spain (6 Mo. LIBOR-1/16) 29/6/02 (semi)	99.91	100.21	-	3.34766		Dec-30
CZECH REPUBLIC KORUNA BONDS						
General Electric Cap. Corp. 10.5% 23/10/98	98.35	99.20	10.97			Oct-23
Nordic Invs. Bk 10.625% 10/11/00	98.50	99.35	10.83			Nov-10
Intl. Fin. Corp 10% 30/4/98	97.55	98.40	11.12			Apr-30
SWISS FRANC DENOMINATED BONDS						
General Electric Cap. Corp. 4 3/4% 2/7/98	103.40	-	-			Jul-02
General Electric Cap. Corp. 4 1/2% 17/12/99	105.50	-	-			Dec-17
DANISH KRONE DENOMINATED BONDS						
Kgdm. of Denmark 9% 15/11/96	99.60	-	-			Nov-15
ECU DENOMINATED BONDS						
United Kingdom 9 1/8% 21/02/01	114.00	114.85	5.18			Feb-21
BRITISH POUND DENOMINATED BONDS						
European Inv. Bk. 7% 22/12/98	100.55	101.40	6.27			Dec-22
JAPANESE YEN DENOMINATED BONDS						
World Bank 4 1/2% 22/12/97 RRSP	104.30	105.15	0.00			Dec-22
CANADIAN DOLLAR DENOMINATED BONDS						
Eksportfinans 7 3/4% 5/11/97	102.75	-	-			Nov-05
Royal Bank of Canada 9 1/8% 7/1/97 RRSP eligible	99.95	101.20	2.47			Jan-07
Ontario Province 10 5/8% 15/7/98 RRSP eligible	109.35	110.60	4.05			Jul-15
SOUTH AFRICAN RAND DENOMINATED BONDS						
ESCOM 11% 1/6/08 (semi)	74.45	75.30	15.70			Dec-01
AUSTRALIAN DOLLAR DENOMINATED BONDS						
Toronto Dominion Bk. Aust. 7.25% 26/2/99 RRSP eligible	101.05	101.90	6.32			Feb-26
NEW ZEALAND DOLLAR DENOMINATED BONDS						
World Bank 12.5% 25/7/97 (semi) RRSP eligible	102.40	-	-			Jan-25
World Bank 8.25% 30/4/99 RRSP eligible	102.15	103.00	6.87			Apr-30
New Zealand Gov't 10% 15/7/97 (semi)	100.70	-	-			Jan-15
New Zealand Gov't 8% 15/7/98 (semi)	101.55	102.40	6.48			Jan-15
Fletcher Challenge 10.75% 15/12/97 (semi)	100.70	101.55	9.25			Dec-15
Fletcher Challenge 10.15% 30/11/98 (semi)	101.90	102.75	8.67			Nov-30
Tranz Rail Ltd. 10% 15/10/99 (semi)	104.30	105.15	8.01			Apr-15
Trans Tasman 9% 27/6/99 (semi)	91.00	91.85	13.09			Dec-27
St. Luke 8.7% 1/4/99 (semi) CV @ 1.00 p/sh	158.40	159.40	5.18			Apr-01
ARGENTINEAN PESO DENOMINATED BONDS						
Bocon Pre 1: 1/4/2001	PAR VALUE 136.1295	108.60	110.35	IRR 13.29		May-01-97
U.S. DOLLAR DENOMINATED FIXED CONV. BONDS						
Atari Corp. 5 1/4% 29/4/02 CV@16.31 p/sh	69.25	-	-			Apr-29
Coeur D'Alene 6% 10/6/02 CV@ 26.00 p/sh	87.25	-	-			Jun-10
Sports & Recreation 4 1/4% (semi) 1/11/00 CV @ 25.5 p/sh	74.75	76.25	11.68			Nov-01
Novacare 5 1/2% 15/11/00 CV @ 26.65 p/sh	88.50	-	-			Jan-15
U.S. DOLLAR DENOMINATED FIXED RATE BONDS						
Queensland Tres. (Gold Bull) 2% 4/3/98	93.00	-95.00	-			Mar-04
World Bank 7 1/8% 27/9/99 (semi) RRSP eligible	102.55	103.40	5.83			Sep-27
T.W.A. 12% 3/11/98 (semi)	98.15	99.00	-			N/A
U.S. DOLLAR DENOMINATED FLOATING RATE NOTES						
Kgdm. of Denmark 25/3/97 (Gold call, JY put),(semi)	94.25	95.75	-	9.50631		Mar-25
Canada Gov't 10/2/99 3 mo. LIBOR - 1/4 (qly), callable @ 100 RRSP eligible	99.64	99.94	-	5.28516		Nov-13
Bocon 1/4/01 (30 day LIBOR) starts paying May 1,97	116.60	-	-			May-01-97
Argentina: Series L:FRB 31/3/05, 6 mo. LIBOR+13/16 (semi)	77.45	78.95	11.71	6.4925		Mar-27
Venezuela: DCB: 18/12/07, 6 mo. LIBOR+7/8 (semi)	80.65	81.50	11.27	6.625		Dec-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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