25 YEARS

FRIEDBERG'S

COMMODITY & CURRENCY COMMENTS

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The futile search for undervaluation

It is a well-known and time-tested truism on Wall Street that when the paddy-wagon comes, it takes the good girls along with the bad ones. In other words, a bear phase punishes "undervalued" securities along with the overvalued ones. There is no safe haven.

A direct corollary to this maxim is that it does not pay to search for value in the late stages of a boom. Instead, those who insist on playing right to the end ought to concentrate on the most liquid securities, even when they are the most overvalued ones. While this may seem paradoxical, it isn't. Rational investors will emphasize liquidity in late stages of a bull market *because they want to minimize exit costs.*

This simple corollary explains why the Intels, Microsofts, and Coca-Colas become pricier and pricier and why suddenly indexing has become the rage. The S&P 500 represent the most liquid securities in the world. They outperform because they are liquid and in turn their outperformance attracts more buying. This virtuous circle is absolutely rational — if riding the most grotesque financial bubble in modern history can be called rational.

This conclusion also explains a little-understood phenomenon: Why is it that normally intelligent investors are seduced by value — and in fact can find pockets of value — at the end of a bull market, at a time when one would expect little of any value? The answer is that the highly liquid and correspondingly overvalued securities make everything else look relatively undervalued: A 15-18 multiple looks cheap in relation to a 30-35 multiple, but of course the latter p-e is insane.

By the same token, a 485 basis-point (bp) spread over Treasuries for Russian debt looks cheap in relation to the approximately equivalent Philippine debt spread of a mere 150 bp, or, at the longer maturities, Russia's 557 bp spread compared with Poland's 138. But neither the Philippines nor Poland are exactly paragons of creditworthiness.

Emerging economies have been living through the prodigal seven years of plenty. They have yet to be tested on the adverse conditions.

This last point is crucial. From a position of near balance in 1987, the combined current account deficit of the 30 leading emerging economies rose to $80 billion in 1995, $107 billion in 1996, and is expected to reach $150 billion this year, representing approximately 3% of their combined GDP. These deficits have been financed by sizable inflows of external resources, a significant portion of which is portfolio purchases like shares and short-term debt instruments. Another substantial portion of these inflows, perhaps as much as 30%, has ended up in the accretion of international reserves, taking them to a total value of $500 billion.

These capital inflows are as much a function of the perceived attractiveness of emerging economies as they are of the vigor of the running speculative juices in the developed economies. A reversal of these flows — the infamous phenomenon of negative resource transfers of the '80s — will wreak havoc on emerging market securities.

Mexico in 1995, South Korea, and more recently Thailand are but three examples of what happens when speculative capital loses confidence and wants out in a hurry. In Thailand, for example, the continuing bear market has cut down the value of equities by over 50% in the short span of one year, and the central bank is fighting a losing battle to maintain the parity of the baht at a cost of sinking the country into a depression. But note that these singular incidents have taken place in the midst of a global economic expansion, and even more importantly, in the midst of a global period of ultra easy money and credit.

In this issue

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

New Hotline Update number

Effective March 7, 1997, our Hotline Update telephone number will change. Please refer to the card enclosed with this issue for the new number.

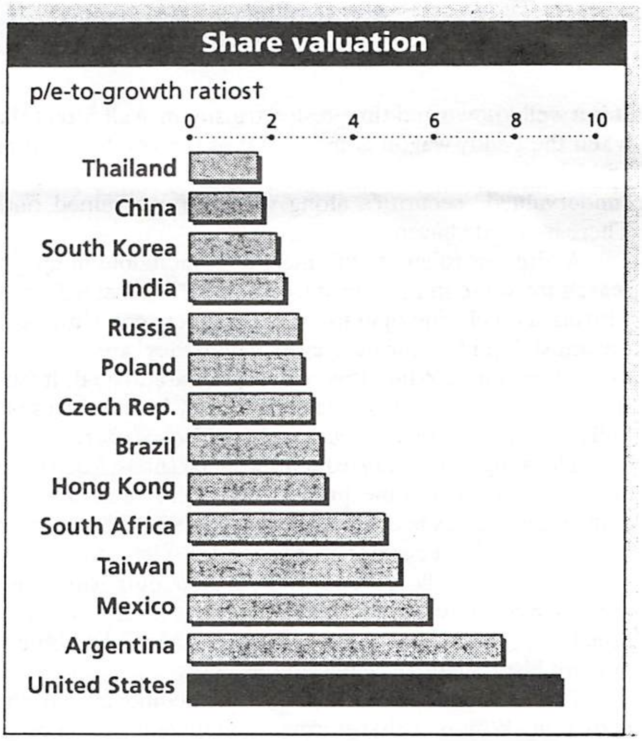
Chased out from Thailand and South Korea, funds flow to Brazil, the Philippines, and Russia, blissfully unaware that the latter's problems are just as serious, if not worse, than the former's. A generalized withdrawal of all emerging markets will have to wait until the credit boom in the developed economies comes to an end.

It should be kept in mind that in the '80s, most of the LDC (less developed countries, now the more politically correct "emerging countries") debt was owed to banks. Debt reduction was negotiated through concerted bank packages that culminated with the Brady deals. The restructurings usually securitized the claims — that is, converted the form of the claims from loans to bonds — and lenghthened the repayment periods, sometimes to as much as 30 years. *Since securitized claims are now much more widely held (because of Brady, and also because of recent successes of the likes of Mexico, Brazil, and Argentina in their launching of global bonds), a future restructuring would be much more difficult to organize and hence less likely. Also, notice should be taken of the fact that the gross reduction in claims payable to banks as a percent of eligible bank debt averaged 38.2% for the stronger emerging economies and much more for those involved in the second and third Brady rounds (Peru, Panama, Ecuador, etc.). This should be compared with average spreads over Treasuries at this time of a mere 430 basis points (J.P. Morgan EMBI).*

Interestingly, and confirming our earlier thesis, there is method to the madness. The International Finance Corporation's (IFC) investable index, which measures the prices of emerging market shares that foreigners can buy, is 7% lower in dollar terms than in December 1993, in sharp contrast to Wall Street, which has since climbed by 75%. Share valuations in the US are substantially "pricier" than in emerging economies (see Chart 1), and yet its market outperformed the IFC index. In fact, with the sole exception of Brazil and Russia, the US market has handily outperformed every other emerging market for the past three years.

It is clear: The search for undervaluation, at this stage, is absolutely futile. Because rewards are not commensurate with risks, liquidity and not value is at a premium. But for a minuscule number of exceptions, we ought to prefer S&P 500 over emerging country stocks and debt, developed country debt over emerging country debt, short maturities over long maturities.

Chart 1



†Jan 31st 1997 p/e ratio divided by expected five-year GDP growth rate

THE ECONOMIST

CURRENCIES

Yen, deutschemark move lower

Japan

Increasingly, regulators in Japan are moving away from forbearance, pointing out that they will close insolvent institutions. This will require large amounts of public money, perhaps as much ¥20 trillion. The discussion in Japan over the use of public funds to bail out private financial institutions has begun. The idea has been presented by Naoto Kan, co-leader of The Democratic Party of Japan. So far, government officials have been opposed to this idea, pointing out that the government and the ruling parties had agreed in December 1995 not to spend public money for purposes other than dealing with the failed housing loan companies.

To further complicate matters, the Ministry of Finance has announced in recent days that it has "guaranteed" Japan's 20 biggest banks. This limited guarantee, of course, can wreak havoc with the rest of the banking system, because depositors are likely to shift funds to the guaranteed institutions. Clearly, the government has as yet not formulated a plan of action to deal with the ever more urgent crisis.

While real economic activity has been improving, with growth for the past four quarters averaging a solid 3.1% and industrial production moving at last above the 1990 peak, the outlook for the coming year is not as optimistic. Leading indicators have been pointing down. Moreover, the fiscal austerity measures recently announced can produce a substantial drag on the economy. The only bright spot is the external sector. While the 12-month cumulative trade surplus of $62 billion continues to decline, the surplus for the last 4 months has been trending higher, running at an annual rate of $67.7 billion. Though encouraging, the surplus will have to more than double before it can make a noticeable dent on overall economic activity.

Japan's agonizingly slow economic adjustment is still on course. A banking crisis lies directly ahead of us. Real estate prices will need to fall even further before we see a true revival of domestic demand. In the meantime, a falling yen will lubricate the adjustment and offset errors in domestic policy. We see no reason to change our bearish stance on the yen.

Germany

There are conflicting statistics coming out of Germany. On one hand, the extraordinary 160,000 rise of unemployment in January and the drop in German capital goods orders in the fourth quarter, 1.7% vis à vis the third quarter and 3% vis à vis the second quarter. On the other hand, despite the unusually harsh winter weather in the latter part of December, German industrial output advanced 1.4% in December, suggesting that GDP should have grown at a 0.2% quarterly rate in the fourth term. As well, the January IFO Business Conditions Index for West Germany increased to 93.3 from 90.0, extending the steady recovery since the middle of 1996. In sum, economic activity remains anemic.

The inflation rate seems to have stabilized around the 1.6% per annum; prospects for a continued reduction in the rate of inflation have dimmed in view of recent 10% slide of the deutschemark against the US dollar. Little wonder that government officials and members of the Bundesbank alike have articulated in many different forms the idea expressed by Chancellor Kohl that the "mark has been fully corrected against the dollar in the last year." The DM is likely to continue under pressure vis à vis the US dollar. Short term, it is likely to strengthen on the cross with the yen, but, long term, it should weaken.

STRATEGY: *On the crosses we continue to favor long positions in the New Zealand dollar — which continues to make new highs on trade-weighted basis — and Sterling versus short positions in the yen. Also remain short yen outright, lowering stops to 85.10, basis March '97, good anytime.*

Chart 2 — Japanese Yen

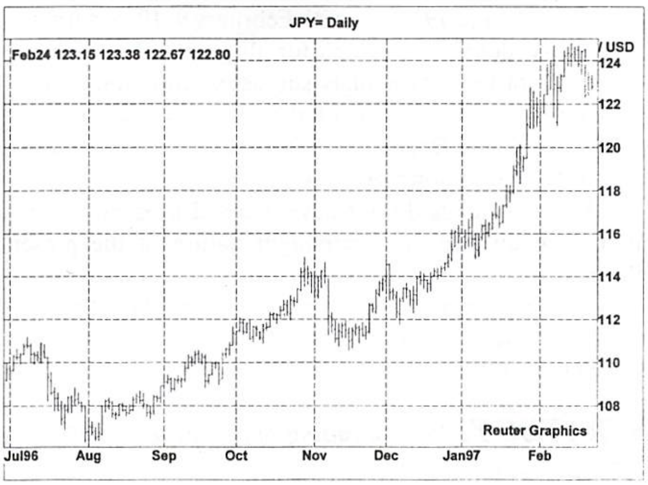
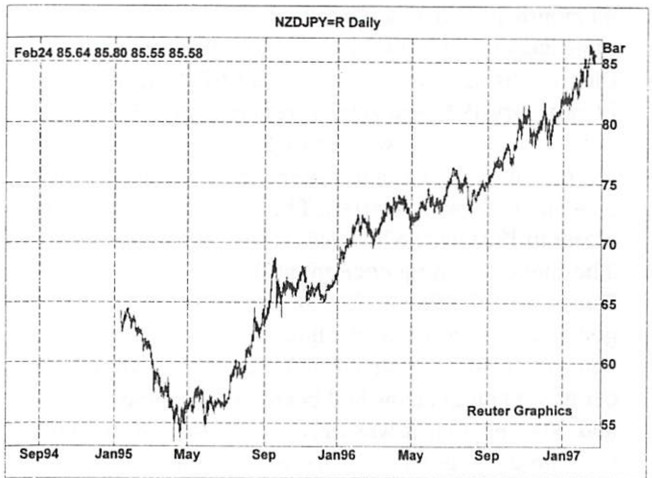


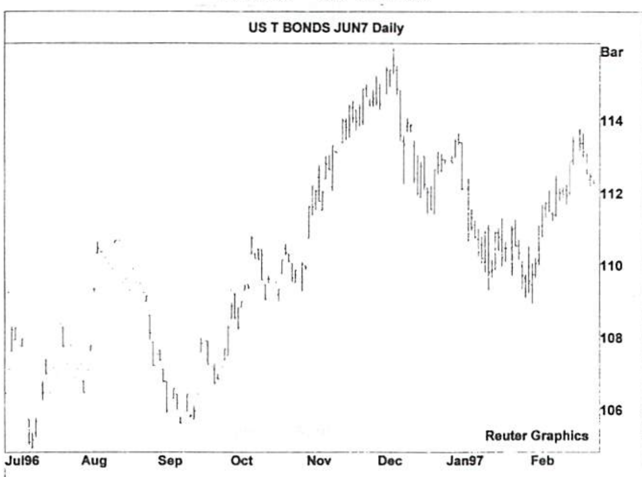
Chart 3 — NZ$/Yen



INTEREST RATE FUTURES

STRATEGY: *Remain long June '97 T-bonds with stops at 109.16, good anytime.*

Chart 5 — US T-Bonds



S&P 500

Play at your own risk

There are a great number of intriguing statistical "facts" that mark the current advance as absolutely unique in US financial history. We have two current favorites.

The first is that the price-earnings ratio of the S&P 500 index is nearly 22 on the basis of *record* earnings. This is the highest p-e that has ever been applied to *record* earnings. During the past century, record earnings have been awarded a p-e of just under 12 on average (John P. Hussman in *Hussman Econometrics*).

The second is offered by Peter Eliades in his *Stock Market Cycles*:

> If we inspected every forty-month time window since the turn of the century and count the number of months that were up from month end to month end during that 40-month period, it might surprise you to discover that there have never been more than 30 up months over any 40-month period this century. In fact, prior to 1996, there had only been two other periods this century when the months up per 40-months reached 30. It occurred in February 1937 and April through August 1961. The February 1937 close was the highest monthly close for the next 8 1/2 years and it preceded a decline of over 50% on the Dow Industrials. The April through August closes in 1961 were 678.7, 696.7, 684, 705.4 and 719.90. The highest subsequence monthly close occurred on December 29, 1961 at 731.14. Before six months had gone by, the Dow had declined almost 30%. Perhaps you can convince yourself that the only two times this century when the Dow had been up to declines of 50% and 30% but that it was only a coincidence. Perhaps you can also convince yourself that although in both October and November of 1996 the Dow had again been up 30 out of 40 months and is about to do so again for the months of January — perhaps you can convince yourself that the other two occasions that led to major declines were aberrations and this time around the Dow need suffer no such decline.
>
> Once you have explained away those prior 'aberrations,' you should then examine the same technique over a 100-month time window. Look at the front page of our November 8, 1996 newsletter. Notice that the greatest number of up months within a 100-month period is 69, registered in December 1961. There have been only two other time periods this century where the number of up months per 100 reached 68. The first of the other top periods occurred in January, February, and April, 1966. Perhaps it was just an accident that January 18 and 19, along with February 9, 1966 market a virtual double top which for all practical purposes would not be convincingly surpassed until almost 17 years later. The second of the other two periods is November and December 1996 and January 1997 (unless the Dow is down over 250 points tomorrow).

These readings do not have magical properties. They merely underscore the overbought nature of the present advance.

We are in uncharted territory and that we should proceed with a great deal of care. No one will ring the bell at The Top.

Play at your own risk.

STRATEGY: *We are raising our stops to 770.00, basis March '97, good anytime.*

Chart 6 — S&P 500

GOLD

What went wrong?

A little more than a year ago (in our November 1995 issue), we penned a piece on gold entitled, "Gold: why we are so bullish." After a short incursion above $400/oz., bullion prices retreated and began a long and gradual decline that recently touched a 3-year low at $336/oz. What went wrong? With the benefit of hindsight one can see that it was neither official sector sales — which at an estimated 208 tonnes were only 12% higher than in 1995 but 56% lower than in 1993 — nor net forward sales, which for the year as a whole were nil.

The single largest destabilizing factor was an item called disinvestment. As pointed out by Goldfields Mineral Services *Gold Update 2*, this item was arguably the most significant component of supply last year; the implied residual of 231 tonnes for 1996 compares with a net investment of 28 tonnes in 1995, for a reversal of 259 tonnes in one year — the largest figure since 1991.

Disinvestments, or the liquidation of investment positions as the name suggests, was carried out mostly through speculative short selling. This activity was partly observable on the Comex and partly not when carried out in the allegedly larger over-the-counter market. Given the size and importance of this market (the London Bullion Market Association disclosed that as much as US$13.2 billion was cleared every working day in January of this year, $11 billion in December, $11.7 billion in November, and $10.5 billion in October to which one must add Comex and over-the-counter trading), it behooves us to hypothesize as to the reasons behind the selling and what it may signify.

Since historically, investors have bought gold as a refuge from bad money, it stands to reason that in periods of low inflation, investors would show a decided lack of interest in gold. This is simple enough, and this may be all or most of the answer — especially when investors have access to debt instruments that yield real returns.

But perhaps the chain of causation begins even earlier. We know that bad credit leads to bad money. While the existence of bad money is not readily apparent, as evidenced by low inflation rates, bad credit is everywhere. We might then be justified in asking why gold prices do not anticipate bad money. And here the answer may be that the extraordinary bull market in financial assets has diverted investors' attention from the coming debacle of credit. If this thesis is correct — that is, that rising stock and bond prices act to eliminate fears of a credit collapse for the majority of investors — then we may have succeeded in identifying the real catalyst for the coming and inevitable bull market in gold.

Lastly, continued fear of demonetization has clearly had a greater impact on the market than the reality. The fear is well-grounded as we commented in earlier issues and has little or nothing to do with the coming into existence of the EMU. It is now our opinion, in contrast to earlier reviews, that the process of demonetization will be accelerated as more and more modern central banks recognize the archaism of international reserves in general and gold in particular in a floating currency regime. (We refer, of course, to central banks of major industrialized countries, not those of emerging economies). The hope, however, is that gold's elasticity of demand is high enough to absorb increasing amounts of official sector sales in coming months and years.

STRATEGY: *Neutral since early April of last year, we turned decidedly bearish around mid-year and advised that traders short this market to take advantage of the downtrend. Investors were kept long via cheap long-term calls. The downtrend remains in force but punctured from time to time by short covering rallies. These rallies revive hopes in the bullish camp and lend the bear phase a renewed lease of life.*

Maintain short positions with stops at 364.70, basis April '97, good anytime.

Chart 7

SOFT COMMODITIES

Cocoa

As the market heads in a southerly direction, one wonders what happened to all the bullish fundamentals and the promise of higher prices. In fact an examination of production and consumption trends alone would leave the casual observer bewildered. Further disbelief will be experienced by the reader when he discovers that the publishers of these pages are actually short this market. After absorbing exclusively bullish sentiments from us, for years now, we can appreciate if subscribers feel slightly betrayed.

There is an old saying in the markets that all market participants fall into one of three categories: bulls, bears and pigs. The implication is that bulls and bears have conviction, will stay the course and ultimately triumph. The pig will buy and sell as the wind blows and never believe in his ideas long enough to see them through to a profitable end. Are we guilty? Not a chance.

The macro-economic and supply/demand fundamentals that formulated our bullish stance to date have not changed at all. Rather, the short position we've recommended is motivated by technical factors. Commodity funds, for the most part, act on signals generated by computerized trading systems, without any regard for the underlying fundamentals. The technicals are so bearish that they've attracted an enormous bubble of short sellers who seem to be in control of the market. In fact, open interest has risen by 15,000 contracts, or 20%, in just the past 2 months. What piques our interest is that despite its size, the open interest is well behaved. Throughout the move, the level of the open interest has followed the market; new lows in price brought new highs in open interest, and small rallies in price were sufficient to "cleanse" the open interest of weak hands (pigs). As long as this pattern endures, the market will keep groping for a floor. We are just surfing the waves along with the commodity funds (bears) but have not abandoned our true long-term outlook, which will keep our quest to become long this market alive (bulls).

Since we are examining the open interest, it pays to investigate who is taking all this cocoa off the hands of the short sellers. Steven Briese, who publishes *The Bullish Review,* a bi-weekly newsletter that analyzes the open interest of all the US commodity markets, indicates that the commercials have been buying up all the "excess" cocoa that the speculators have been selling short, putting the commercial holdings of cocoa at historically high levels. Mr. Briese views this type of situation as a buy signal, because it is always assumed that one would want to be on the same team as the informed commercials who actually create the supply/demand balances rather than on the side of the hopeful speculator who is guessing. This says little for our current short position. But then again Mr. Briese's system, which has no claim to precise timing of the signals, is not intended to be a short-term trading tool but rather one that allows us to see what knowledge we can garner from the behavior of market participants. Demand is obviously alive and healthy as commercial consumers are sopping up every tonne of cocoa that speculators are hurling at them.

Admittedly, getting very bullish right now is a futuristic endeavor. On Feb. 4 the ICCO reported that the production/consumption deficit this year will be 225,000 tonnes. This brought upon by a 10% drop in production and a 3% rise in grindings. This would bring ending stocks down to 1.162 million tonnes, but that still represents a burdensome 41% of consumption. The ICCO report has been the most recent of major analysts'; other analysts don't figure the ending stocks to be quite that high. Still, it is a stubborn mountain of stocks and allows the bears quite a rationalization for trying to break the back of the market.

As many commodity markets begin adapting to the era of the on-time inventory management system, cocoa's carryover stocks leave it in the dark ages. Our scenario sees the market remaining weak, but since we know the demand is out there, consumers will eat into the stockpile at an ever increasing rate. The bull markets in grains saw rationing emerge at high prices, bringing stocks back to acceptable levels. Much the same, but at the other end, this bear market will bring dormant buyers into the market, creating new and permanent chocolate lovers.

STRATEGY: *Remain short as per Hotline Update of Feb. 11, leaving stops at 1385, basis May '97, good anytime.*

Corn

Given current conditions, making a very bullish case for corn prices would not be too easy a task. Making a bearish case, however, would be far more difficult. Since liquidating our position last year, we left the market alone and allowed the bull market to die peacefully. In fact, from the sidelines we took some notes, enriching our understanding of markets. As old crop prices rose incessantly, we pointed repeatedly to the tightness seen in the outlandish backwardation. Would traders foolishly not close a discount of over $1.50/bushel between the old and new crop prices, or were they being coldly objective about the likelihood of a return to a normal crop?

Inverted markets are fun while they last, but overstaying one's welcome could be punishing. Astute and non-greedy farmers knew the answer and were able to hedge their corn crops at prices over a dollar higher than current prices. The crop did not disappoint, as it registered a 26% increase over the previous year's disastrous crop. Coupled with the bountiful crop, rationing occurred amongst the importers of corn, as profits were being choked by the ridiculous prices. As we naively spoke of US exports reaching 60 million tonnes, 3.5 tonnes above the USDA forecast, buyers of US corn began to close the ports. The USDA now predicts that foreign buyers will have an appetite for no more than 48 million tonnes this year down 15% from last year's exports.

That's the bad news for prices. Fast forward to the present. The market bottomed out in early November and is crawling along a base. The supply side awaits planting intentions. The demand side, however, tells a different story and would seem to indicate that the downside is limited. The excellent crop and rationing have ensured that short-term supplies are adequate. In addition the huge 803 million tonne sorghum crop has added further assurance that there will be ample carbohydrate feed supplies for the immediate future. But that speaks only for the short term.

Domestic demand never turned down in earnest. While domestic demand dropped 13% last year, the USDA forecasts that the 1996-97 season will see a return to 6.8 million bushels of domestic consumption, 9% above last year, and only 5% less than the record consumption of the 1994-95 season.

Exports are on the mend as well. The season started with export commitments coming in like a lamb. But at the moment it looks like they will go out like a lion. When the marketing year began, commitments looked pitiful. As the market kept erasing more and more of the rich price tags, importers lost their shyness and became buyers once again. If the commitments were to continue at this pace, an average of one million tonnes per week for the past six weeks, the USDA projections will surely rise.

The large sorghum crop helped bring last year's shortages under control. Upon examining the USDA's sorghum statistics, further evidence emerges that consumption is running neck-and-neck with growing supplies. Domestic consumption and exports of sorghum is expected to soar to 754 million tonnes, up 46% over last year. While the large crop did alleviate some pressure from overburdened corn supplies it did nothing for rebuilding supplies. After domestic and export consumption is accounted for, only 67 million tonnes of sorghum will remain in stocks, only 9% of consumption.

Although the 959 million bushels of carryover, already down a couple of hundred million bushels from last month's USDA report, feels a whole lot better than last year's 426 million-bushel the-world-is-coming-to-an-end figure, the situation is hardly relaxed.

STRATEGY: *As is quite obvious, we are friendly to the market. However, we believe that soymeal holds more promise (see the next story).*

Soymeal

We will not even attempt to feign any false modesty. When it first became clear that the US would harvest a bumper a record soybean crop, the USDA spoke of a carryover of 220 million bushels. We spoke of a carryover of 140 million bushels and didn't feel even a bit silly. Export commitments left the starting gate with such a bang that we were certain the USDA was underestimating their export projections and understandably so, as they use historical data in their models. For months now, the USDA supply/demand situation reports have been inching in our direction. Finally in the Feb.12 report they raised exports and the domestic crush high enough to report a meagre 140 million bushel carryover, the lowest in 20 years.

Those who follow the economy in China should not be surprised, nor should they be surprised about the explosive growth in their demand in the coming years. Earlier this month, the US Feed Grains Council held a convention in Phoenix, Arizona. Their findings on the Chinese scene: China will import 1.5 million tonnes of feedgrains this year, 4.255 million tonnes next year, and double that the following year! Absolutely mind-numbing statistics.

Although they represent the US trade and could have somewhat of a vested interest in slight embellishments on behalf of their clients' interests, nobody could look you straight in the eye and tell a lie like that. It is true, however, that a USDA economist commented on the group's report and found it to be "a little bit rosy." Nevertheless, even leaving room for some exaggeration, we have seen, and have written about on these pages, other, similar reports on the expansion of Chinese poultry and livestock populations.

Coming back to the here and now, the February report changed the supply picture a bit by raising both key South American crops. They raised Brazil and Argentina half a million tonnes each to 26.5 million tonnes and 13.5 million respectively. As far as rebuilding stockpiles is concerned, this was neutralized at least in part by the raising of exports from the two countries by 200,000 tonnes each.

The drop of 15 million bushels in ending stocks from last month's 155 million bushels, was made up of an additional 5 million bushels of exports and 10 million tonnes added to the domestic crush. While the talk in soybeans generally focuses on export demand, the stateside domestic consumption has been showing signs of growth as well. Bill Gary of *Price Perceptions* (February 15) tells us "the crush has been at record levels each week since late October. However instead of declining seasonally into late winter, it has remained near capacity through the latest reporting week. If the crush for the crop year is to equal the USDA's estimate of 1410 million bushels, it must be reduced to 26.1 million bushels per week compared to the current rate of 30.5 million."

It is quite clear. Demand for protein meal is not limited to export or domestic consumption, but is a global phenomenon. We begin to understand why the magnitude of the harvest correction was so much milder than the corn and wheat markets. End users are scrambling for supplies. Even soybean oil, which has been languishing in the doldrums, will see exports double last year's figures.

It is difficult to find a hole in the bullish argument. As the market approaches the previous high of $260 per tonne, and corrections can make traders queasy, we continue to view this market, to the extent that futures trading can be considered an investment, as a long-term hold.

STRATEGY: *Remain firmly long, with stops at 219.50, basis March '97, good anytime.*

— Sholom Sanik

FRIEDBERG CAPITAL MARKETS

Peso vs US$ spreads on Argentine debt

On numerous occasions we have argued that the risk premium on peso-denominated debt was unwarranted, given the monetary regime that was and still is in place. The convertibility system fixed the exchange rate at a level that equated the monetary base to foreign reserves. By making the money supply a function of reserves, it provided higher reserve coverage to better cope with liquidity problems. As well, convertibility did not allow for the central bank to be a lender of last resort, which reduced the probability of both devaluation and capital flight. The regime was tested by and withstood the effects of the Mexican peso crisis and its impact on the reserves of the Argentine banking system.

In our December 1995 issue, we specifically called attention to risk premiums of over 1,000 basis points (bp) observed in November 1995 between the Pre 1 Bocon (peso-denominated) and Pre 2 Bocon (US$-denominated) — both having otherwise identical characteristics.

Since then, the risk premium has declined significantly in absolute terms from over 1,000 basis points, as noted above, to 175 basis points in February 1996.[1] Over the same period, however, Argentine yields in general have declined such that the yield on Pre 1's and Pre 2's are 355 bp and 180 bp over US Treasuries, respectively. The question remains: Has the reduction in the absolute risk premium been a function of decreased risk perception or simply the result of decreasing yields in general?

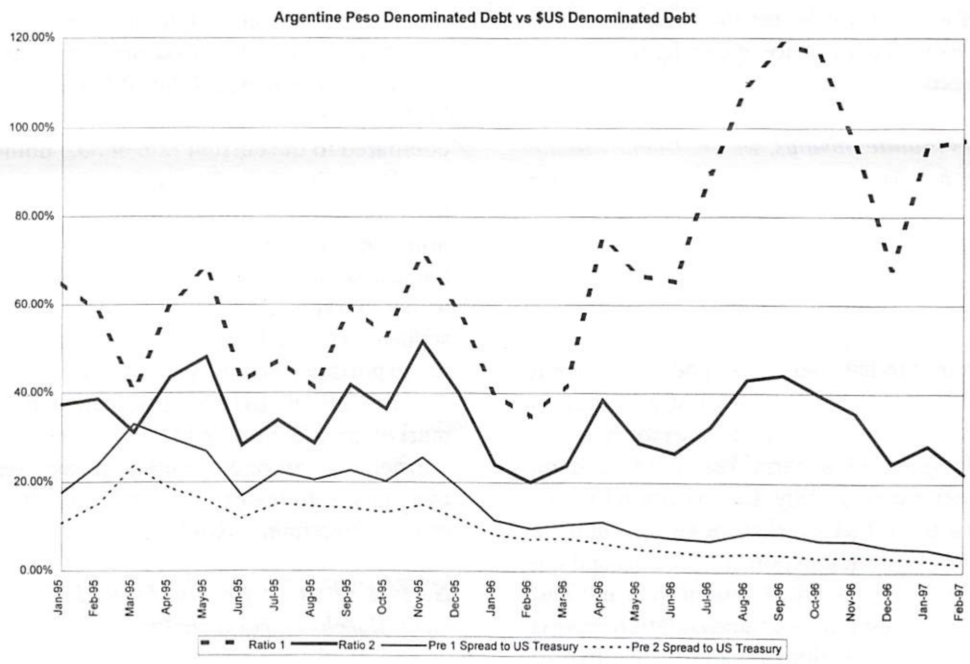
The true premium is a topic open for much debate; however, an exercise in relative spreads provides some insight into the past and current perception of Argentina's currency risk. Chart 9 provides the spread over US Treasuries for both the Pre 1's and Pre 2's as well as two relative measures. The first measure noted as Ratio 1 refers to the ratio of peso to US$ spreads over Treasuries, while Ratio 2 refers to the ratio of peso to US$ dollar yields. At best, these statistics indicate that on a relative basis, the risk premium on peso-denominated debt has remained fairly constant (between 20% and 40%) since January 1995. Therefore, we conclude that although the risk premium has experienced a large absolute decline, there has not been a decline in perceived currency risk in relative terms.

STRATEGY: *Despite earlier indications that we were prepared to advise selling Argentinean debt, we have demurred. For one thing, Argentina still trades wider than Brazil — and it should not. For another, peso debt is still cheap, as demonstrated, relative to dollar debt. Hang in.*

— Peter O'Sullivan

[1]Historical data provided by Banco Mildesa

Chart 9



Ratio 1 = ratio of peso to $US spreads over treasuries using Pre 1 and Pre 2 Bocons
Ratio 2 = ratio of peso to $US yields using Pre 1 and Pre 2 Bocons

FRIEDBERG CAPITAL MARKETS

German government bonds: An attractive *dollar* return

As credit spreads become increasingly narrow, it is more difficult to find higher-yielding investment opportunities. In such an environment, the fund manager must find new and creative means to provide investors with high quality returns. We believe one such opportunity exists with German government bonds. The strategy involves a long position in 10-year government bonds with additional pick-up through a forward currency sale.

The position and relative steepness of the German yield curve relative to the US yield curve (see Chart 10) implies a sizable forward premium on the deutschemark (DM). At the 1-year point, the differential between US dollar and DM deposit rates is 253 basis points. This differential translates into a forward premium of 400 points[1] and a 2.4% return to forward sellers of DMs.

The return on the currency sale is certain; however, the long position in 10-year bonds is subject to interest-rate risk. It is our belief, however, that interest rates in the short term will not increase. Suffering form numerous structural inefficiencies, the German economy is characterized by low growth, high unemployment, and increasing demands on deteriorating fiscal balances. In our opinion, there's very little to suggest an upward movement in interest rates.

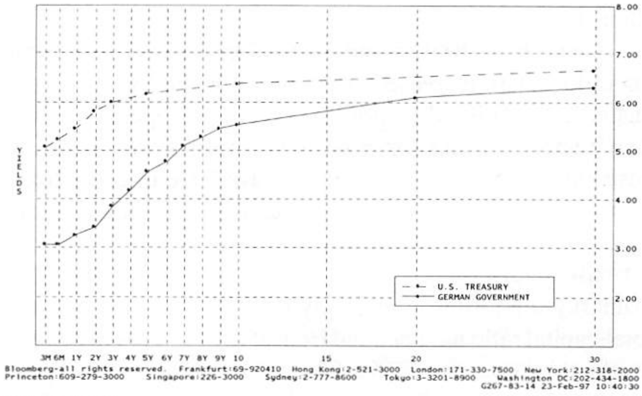
The anticipated yield on this trade includes the annualized yield on the securities themselves as well as the pick-up on selling the DM forward. The yield to maturity on 10-year bonds is approximately 5.5%. Combined with the additional pick-up on the currency, the expected return is 7.9% — quite respectable, given the credit exposure is German sovereign risk.

STRATEGY: *It is recommended that large and sophisticated investors with access to forward hedging facilities capitalize on this trade idea. Investors will receive a relatively high yield, given the credit quality of the issuer.*

— Peter O'Sullivan

[1]Spot rate of 1.6870 DM/US$ vs. forward rate of 1.6470 DM/US$.

Chart 10 — Yield curve comparison



FRIEDBERG CAPITAL MARKETS

Petromet Resources Limited

Security: Convertible Subordinate Debentures
Maturity: March 31, 2004
Issue amount: $25 million
Recent price (offer): $90.00
Yield to maturity: 8.29%
Coupon: 6.5%
Current yield: 7.18%
Conversion price: $9.50
Recent stock price: $3.30

Petromet Resources Limited (PRL) is an oil and gas exploration, development, and production company, concentrating its activities in west-central Alberta. The company is primarily a natural gas producer at approximately 80% of throughput with oil and natural gas liquids representing the balance. Its strategy "is to control operations from the exploration stage through to production and marketing. The company generates prospects internally, maintains high working interests, and continuously adds to an extensive undeveloped land base."

PRL had experienced much enthusiasm from the investment community until late 1994. At that time, the stock declined rapidly and has since fallen to approximately $3.00 per share (see Chart 11). The reasons for this, according to the company, were a relatively high debt load, natural gas price declines, and disappointing exploration results. Analysts have noted that the decline is consistent with the company not meeting expected production and growth levels. As a result, the company has acted to reduce the amount of leverage and has increased its production year over year.

Financial performance

Over the first three quarters of 1996, oil and natural gas prices have increased from a low of $14.98 per BOE (barrels of oil equivalent) to $16.67 per BOE. Combined with production increases over this same period, sizable growth in petroleum and natural gas revenues have resulted. Based on production expectations and observed natural gas prices through the fourth quarter, this trend is expected to continue.

Operating costs peaked at the end of 1995, reaching approximately 16% of petroleum and gas revenues. Since that time, third-quarter results show these costs declining to 13% for the 9-month period and 11% for the third quarter alone. The company says that increased volumes through existing infrastructure and its owner/operator strategy will continue to ensure production at a low cost.

Given the large amounts of depletion expense on the income statement, it would be more appropriate to look at cash flow to evaluate performance. Operating cash flow per share amounts, however, are skewed by very large variations in non-cash working capital. Therefore, a more appropriate measure would be the use of fund flows from operations. This amount is simply cash flow from operations before changes in non-cash working capital. Quarterly and year-to-date (YTD) ratios have been annualized for comparative purposes (see Chart 12).

On both an absolute and per BOE basis, fund flows from operations have increased as a result of higher productivity, higher realized oil and gas prices, and declining operating costs. The higher netbacks (revenues *less* royalties *less* operating costs) increase the residual amount available to cover fixed overhead, debt service, taxes, and reserve replacement costs.

Credit quality

Primarily the result of an equity issue in 1995, the debt-to-total-capital ratio has declined from 55.24% in 1994 to 38.68% for the third quarter of 1996. The company has a stated goal that it will strive to "align its total debt, over time, to less than two years' cash flow." The ratios for both operating cash flow and fund flows from operations suggest that the company has improved towards its goal.

As of the third quarter of 1996, asset coverage based on historical cost is 2.64 times. Using the current market capitalization as a proxy for net asset value increases the coverage 3.67 times. The current market capitalization is consistent with analysts' estimates of the company's NAV based on current gas prices.

The fixed charge coverage ratios, included in Chart 13, indicate that there are adequate earnings and cash flows to service the existing level of debt. Some of the ratios provided deduct the cost of replacing the current amount of production at the 3-year average of $6.74 per BOE to more accurately reflect the cash available for debt service. EBITDA-to-interest-expense coverage declines to 2.13 times from 5.10 after deducting replacement costs from EBITDA. As well, fund-flows-from-operations-to-interest-expense coverage declines to 1.14 times after deducting replacement costs. An important difference between EBITDA and fund flows from operations is that the former is measured before interest and the latter after interest. The implication being that fund flows from operations already includes 1 times interest coverage.

Based on the year to date, ending September 30, 1996, the company's breakeven natural gas price is approximately $13.30 per BOE (see Chart 13). In other words, if the price of natural gas had declined to an average of $13.30 per BOE for the 9 months ended September 30, 1996, the before-tax cash flow after replacing reserves at the 3-year average of $6.74 per BOE would be zero. The current Alberta spot price is approximately $14.50 per BOE. The average price received per BOE since 1994 has been $15.90 with a low price of $14.10 per BOE in 1995. Without trying to predict the evolution of natural gas prices, we simply view this breakeven amount as additional downside protection.

Convertible notes

To arrive at the investment value of these bonds, a different approach had to be taken, because a comparable straight bond could not be found. Our approach will entail valuing the individual components of the convertible — straight debt and call option[1] — at the time of issue. We then compare the investment value at that time with the bond's present yield.

At issue, the value of the option would have been approximately $4.19 per share, which implies a value of $44.04 per $100 face value. Subtracting this amount from the bond's price of $116.30 gives you an implied price on the straight debt of $72.26 and corresponding yield to maturity of 11.23%. At that time, the resulting spread over government bonds would have been 267 basis points (bp).

The yield to maturity on the convertible is now 8.29%, with a government bond of similar maturity yielding 5.66% — a difference of 263 bp. Given that the credit quality of the company has improved, one can conclude that the bond is trading at or inside its investment value in terms of absolute spread. Moreover, in percentage terms the bonds now trade inside their investment value, because the spread now represents a greater percentage of the respective government benchmark. In any case, we can conclude that the investor is not paying a premium for the conversion feature.

These notes are not callable before March 31, 1999, unless the closing price of the common shares for 30 consecutive trading days is $15.25 per share or more. After March 31, 1999, the debentures are redeemable in the event that the weighted average price of the common shares during the prior 30-day period is not less than 130% of the conversion price.

STRATEGY: *We believe the improving credit fundamentals of Petromet warrant the attention of aggressive fixed-income investors. The notes offer an attractive yield and a free call option on the company's stock. Furthermore, our optimism is supported by recent insider buying by company directors and executives.*

— Peter O'Sullivan

[1]Using a Black Scholes model with a stock price of $9.375, a strike price of $9.50, a risk free rate of 6.19%, and a volatility of 9.94%, which was the lowest volatility of both the TSE 300 index and the TSE Oil and Gas index.

Chart 11

Chart 12 — Petromet Resources Limited — Financial Ratios

RATIOS	1994	1995	1996 Q1	1996 Q2	1996 Q3	YTD
Debt to Total Capital	55.24%	42.68%	39.25%	38.98%	38.68%	38.68%
Debt to Operating Cash Flow	7.90	19.47	2.94	6.49	2.00	3.02
Debt to Fund Flows from Operations	8.90	5.25	4.09	2.91	3.08	3.29
Profit Margin with Extraordinary Items	13.39%	11.99%	43.49%	24.88%	10.85%	25.63%
Profit Margin without Extraordinary Items	13.39%	8.71%	11.10%	15.69%	10.85%	12.71%
EBIT to Interest Expense	2.03	1.59	1.61	2.80	2.64	2.32
EBITDA to Interest Expense	4.00	4.29	3.98	5.80	5.69	5.10
EBITDA less Replacement Cost to Interest Expense	1.77	1.26	1.51	2.58	2.39	2.13
Operating Cash Flow to Interest Expense	3.28	0.87	4.17	2.16	7.24	4.47
Fund Flows from Operations to Interest Expense	2.91	3.21	2.99	4.81	4.69	4.11
Fund Flows less Replacement Cost to Interest Expense	0.69	0.18	0.52	1.59	1.40	1.14
Current Ratio	0.83	1.71	1.15	2.06	1.14	1.14
Operating Cash Flow per Share	0.20	0.08	0.45	0.20	0.66	0.44
Fund Flows from Operations per Share	0.17	0.29	0.32	0.45	0.43	0.40
Price to Operating Cash Flow	30.5	50.8	6.5	13.5	4.3	6.5
Price to Fund Flows from Operations	34.4	13.7	9.1	6.1	6.7	7.1
Fund Flows from Operations per BOE	8.83	7.14	8.17	10.06	9.59	9.33

Chart 13 — Petromet Resources Limited

	1994		1995		1996 Q1 YTD		1996 Q2 YTD		1996 Q3 YTD		Breakeven
Number of BOE Sold	523		1278		332		714		1092		
Royalties	15.40%		12.70%		13.40%		11.30%		13.50%		
Operating Cost per BOE	$2.40		$2.51		$2.42		$2.27		$2.17		
Avg Price - Natural Gas (per mcf)	$1.83		$1.41		$1.51		$1.50		$1.53		
Avg Price - Natural Gas (per BOE)	$18.30		$14.10		$15.10		$15.00		$15.30		
Avg Price - Oil & NGL (per bbl)	$17.56		$17.86		$21.26		$21.37		$21.99		
Total Price - Nat Gas, Oil & NGL (per BOE)	$18.25		$14.98		$16.45		$16.45		$16.67		
Amount of Oil & NGL (bbl)	35	6.76%	299	23.40%	73	21.92%	163	22.76%	224	20.48%	
Amount of Gas (BOE)	488	93.24%	979	76.60%	259	78.08%	552	77.24%	868	79.52%	
Petrol and Nat Gas	9,548	$18.25	19,139	$14.98	5,457	$16.45	11,749	$16.45	18,198	$16.67	15,825
Royalties		2.81		1.90		2.20		1.86		2.25	2,457
Operating Costs		2.40		2.51		2.42		2.27		2.17	2,369
Netback		$13.04		$10.57		$11.83		$12.32		$12.25	10,999
General and Administrative										1.06	1,160
Interest on Debt										2.27	2,481
Cash Flow from Operations										$8.91	7,358
Replacement Cost per BOE										6.74	7,358
Cash Flow after Replacement Cost										$2.17	0

Chart 15
Recommended current portfolio allocations

1. 10-year Bunds, hedged (US$)	15%
2. Petromet Resources cv 6.5/2004 (C$)	5%
3. KIPT 9% cv (NZ$)	10%
4. Canada FRN (US$)	45%
5. The Learning Co. 5.5% cv (US$)	5%
6. Sports & Recreation 4.25% cv (US$)	5%
7. New Zealand Gov't 8% (NZ$)	5%
8. Kingdom of Denmark FRN (Sterling)	10%

HOTLINE UPDATE

Flash Update: Monday, January 27, 1997:
Good morning for Monday, January 27, 11:00 am. This is a flash update. Liquidate long March S&P at the market, currently trading at 771.00, cancelling the previous stop of 760.00, good anytime, recommended in the most recent newsletter of January 26.

Tuesday, January 28, 1997:
Good afternoon for Tuesday, January 28. There are no changes or new recommendations.

Flash Update: Wednesday, January 29, 1997:
Good afternoon for Wednesday, January 29, 5:00pm. This is a flash update. Buy March S&P at the market, placing stops at 760.00, good anytime.

Friday, January 31, 1997:
Good afternoon for Friday, January 31. There are no changes or new recommendations. The following is a recap of this week's recommendations.

- On Wednesday, January 29 we advised, via flash update, to buy March S&P at the market, placing stops at 760.00, good anytime. This position was executed at the next day's opening of 780.00.

Flash Update: Monday, February 3, 1997:
Good afternoon for Monday, February 3, 5:00 pm. This is a flash update. Buy June T-bonds at the market, placing stops at 109.16, good anytime.

Tuesday, February 4, 1997:
Good afternoon for Tuesday, February 4. We have one new recommendation. Sell May copper at the market, placing initial stops at 105.00, good anytime.

Friday, February 7, 1997:
Good afternoon for Friday, February 7. There are no changes or new recommendations. We repeat the recommendations made during the past week.

- On Monday, February 4, via flash update, we advised to buy June T-bonds at the market, placing stops at 109.16, good anytime. This position was executed at the next day's opening of 111.15.
- On Tuesday, February 4, we advised to initiate a short position in May copper at the market, placing stops at 105.00. This positions was executed at the next day's opening of 101.60 and traded above 105.00, and we have therefore been stopped out.

Tuesday, February 11, 1997:
Good afternoon for Tuesday, February 11. We have two new recommendations. Sell short May cocoa, at the market, placing initial stops at 13.85, good anytime and to raise stops on long March soymeal to 229.00, good anytime.

Friday, February 14, 1997:
Good afternoon for Friday, February 14. There are no changes or new recommendations. We repeat the recommendations made during the past week.

- On Tuesday, February 11, we advised to sell short May cocoa at the market. This position was executed at the next day's opening of 12.74, placing initial stops at 13.85, good anytime and to raise stops on long March soymeal to 229.00, good anytime.

Tuesday, February 18, 1997:
Good afternoon for Tuesday, February 18. We have one new recommendation. Raise stops on long March S&P to 770.00, good anytime.

Flash Update: Wednesday, February 19, 1997:
Good afternoon for Wednesday, February 19, 5:00 pm. This is a flash update. We have one new recommendation. Buy April crude oil at the market, placing stops at 2120, good anytime.

Friday, February 21, 1997:
Good afternoon for Friday, February 21. This is a complete summary since our last market letter dated January 26, of all liquidations of open positions and new recommendations that remain outstanding.

- On Monday, January 27, via flash update, we advised to liquidate long March S&P at the market, good anytime. This position was executed at the next day's opening of 778.50.
- On Wednesday, January 29, via flash update, we advised to buy March S&P at the market. Stops were placed at 760.00, good anytime and subsequently raised to 770.00, good anytime. This position was executed at the next day's opening of 780.00.
- On Monday, February 3, via flash update, we advised to buy June T-bonds at the market, then trading at 111.15, placing stops at 109.16, good anytime.
- On Tuesday, February 11, we recommended to sell short May cocoa, at the market, placing initial stops at 1385, good anytime. This position was executed at the next day's opening of 1274, placing initial stops at 1385, good anytime and to raise stops on long March soymeal to 229.00, good anytime.
- On Wednesday, February 19, via flash update, we advised to buy April crude oil at the market, placing stops at 21.20, good anytime. This position was executed at the next day's opening of 22.13.

Chart 14 — Foreign Currency Bonds

DATE: February 21, 1997 *We offer the following Bonds subject to change without prior notice: Minimum US $5000 (CDN $7000)*

		BID	OFFER	YTM	CURR. COUPON	NEXT INTEREST PAYMENT DATE
DEUTSCHE MARK DENOMINATED BONDS						
World Bank 7 1/4% 13/10/99 RRSP eligible		107.95	108.80	3.67		Oct-13
World Bank 9% 13/11/00 RRSP eligible		118.00	-	-		Nov-13
Kingdom of Denmark 6 1/8% 15/04/98		102.50	-	-		Apr-15
Argentina 8% 5/10/98		103.60	-	-		Oct-05
Kgdm. of Spain (6 Mo. LIBOR-1/16) 29/6/02 (semi)		99.89	100.19	-	3.1875	Jun-30
CZECH REPUBLIC KORUNA BONDS						
General Electric Cap. Corp. 10.5% 23/10/98		99.60	-	-		Oct-23
Nordic Inves. Bk 10.625% 10/11/00		99.60	-	-		Nov-10
Intl. Fin. Corp 10% 30/4/98		98.30	-	-		Apr-30
SWISS FRANC DENOMINATED BONDS						
General Electric Cap. Corp. 4 3/4% 2/7/98		102.90	-	-		Jul-02
General Electric Cap. Corp. 4 1/2% 17/12/99		105.80	-	-		Dec-17
DANISH KRONE DENOMINATED BONDS						
Kgdm. of Denmark 9% 15/11/98		108.20	109.05	3.47		Nov-15
ECU DENOMINATED BONDS						
United Kingdom 9 1/8% 21/02/01		115.15	116.00	4.64		Feb-21
BRITISH POUND DENOMINATED BONDS						
European Invt. Bk. 7% 22/12/98		100.55	101.40	6.15		Dec-22
Kgdm. of Denmark FRN 28/8/98 3mo LIBOR-12.5b.p.(qtly)		99.87	100.17	-	6.29688	Feb-28
JAPANESE YEN DENOMINATED BONDS						
World Bank 4 1/2% 22/12/97 RRSP		103.25	104.10	-0.49		Dec-22
CANADIAN DOLLAR DENOMINATED BONDS						
Eksportfinans 7 3/4% 5/11/97		101.90	-	-		Nov-05
Ontario Province 10 5/8% 15/7/98 RRSP eligible		108.15	109.40	3.53		Jul-15
SOUTH AFRICAN RAND DENOMINATED BONDS						
ESCOM 11% 1/6/08 (semi)		78.90	79.75	14.73		Jun-01
AUSTRALIAN DOLLAR DENOMINATED BONDS						
Toronto Dominion Bk. Aust. 7.25% 26/2/99 RRSP eligible		100.70	101.55	6.40		Feb-26
NEW ZEALAND DOLLAR DENOMINATED BONDS						
World Bank 12.5% 25/7/97 (semi) RRSP eligible		101.20	-	-		Jul-25
World Bank 8.25% 30/4/99 RRSP eligible		101.25	102.10	7.15		Apr-30
New Zealand Gov't 10% 15/7/97 (semi)		100.35	-	-		Jul-15
New Zealand Gov't 8% 15/7/98 (semi)		100.65	101.50	6.84		Jul-15
Fletcher Challenge 10.75% 15/12/97 (semi)		100.60	-	-		Jun-15
Fletcher Challenge 10.15% 30/11/98 (semi)		100.95	101.80	9.00		May-30
Tranz Rail Ltd. 10% 15/10/99 (semi)		101.70	102.55	8.88		Apr-15
Trans Tasman 9% 27/6/99 (semi)		92.65	-	-		Jun-27
St. Luke 8.7% 1/4/99 (semi) CV @ 1.00 p/sh		150.35	-	-		Apr-01
Kiwi Income Prop. Trust 9% 30/9/03 (semi)		123.50	124.50	N.A.		-
ARGENTINEAN PESO DENOMINATED BONDS	PAR VALUE			IRR		
Bocon Pre 1: 1/4/2001	137.7305	122.90	124.65	8.97		May-01-97
U.S. DOLLAR DENOMINATED FIXED CONV. BONDS						
Atari Corp. 5 1/4% 29/4/02 CV@16.31 p/sh		59.75	-	-		Apr-29
Coeur D'Alene 6% 10/6/02 CV@ 26.00 p/sh		89.25	-	-		Jun-10
Sports & Recreation 4 1/4% (semi) 1/11/00 CV @ 25.5 p/sh		73.25	74.75	13.11		May-01
The Learning Co. 5 1/2% 1/11/00 CV @ $53.00 p/sh		77.25	78.75	12.93		Nov-01
U.S. DOLLAR DENOMINATED FIXED RATE BONDS						
Queensland Tres. (Gold Bull) 2% 4/3/98		93.45	94.20	-		Mar-04
World Bank 7 1/8% 27/9/99 (semi) RRSP eligible		102.65	103.50	5.65		Sep-27
T.W.A. 12% 3/11/98 (semi)		97.90	98.75	-		N/A
U.S. DOLLAR DENOMINATED FLOATING RATE NOTES						
Kgdm. of Denmark 25/3/97 (Gold call, JY put),(semi)		92.50	94.00	-	9.50631	Mar-25
Canada Gov't 10/2/99 3 mo. LIBOR - 1/4 (qtly), callable @ 100 RRSP eligible		99.75	100.05	-	5.25391	May-13
Bocon 1/4/01 (30 day LIBOR) starts paying May 1,'97	PAR: 131.6312	125.75	-	-		May-01-97
Argentina: Series L:FRB 31/3/05, 6 mo. LIBOR+13/16 (semi	PAR: 98	90.60	92.10	8.45	6.625	Mar-27
Venezuela: DCB: 18/12/07, 6 mo. LIBOR+7/8 (semi)		90.00	90.85	8.76	6.50	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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