

# FRIEDBERG'S

## COMMODITY & CURRENCY COMMENTS

Friedberg Commodity Management Inc.



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## Commodity prices spell war, inflation and a continuing fall in *real* interest rates

The steady fall of the US dollar juxtaposed against rapid monetary growth, massive fiscal expansion, and the near certainty of at least one war make nonsense of the fears of deflation. In fact, we firmly believe we are in for the most sustained period of rising prices since the early '70s.

Chart 1 depicts a diffusion index – when the nearest contract is higher than one year ago, we record a plus one, and when it is lower, we record a minus one – based on the 17 components of the CRB Index. The force and urgency of the upmove is reflected in the breadth of the participation – 15 out of 17 commodities are higher than one year ago – its highest reading in almost 20 years (or ever since we began tracking it)!

The fact that commodities with relatively poor prospects (because of perceived excess supply conditions as readers of our sister publication, *Focus on Futures*, are well aware) are also nudging 12-month highs, tells us a great deal about this incipient boom: Hoarding, in markets used to living on “just in time” inventories, may be distorting the usual supply/demand balances. The hoarding may have been *triggered* by war fears but it is *fed and sustained* by the enormous liquidity built up over the past six years.

For a dramatic corroboration of this fact, check Chart 2 (M2) and Chart 3 (yield spread). Monetarists are right when they suggest that inflation is a monetary phenomenon; unfortunately, they are not good at timing the precise moment at which prices begin to accelerate.

Inflation, one would have to say, remains latent until some extraneous and momentous event – political, military, or economic – triggers it, much as a spark causes a fire in the presence of combustibles. In economic jargon, velocity stops declining as it has been doing for many years (or, in the worst case, begins to rise) and fails to offset the double-digit increases in money supply.

In our view, an important acceleration of inflation is a certainty. The first-round effects of this surge in prices on expected economic growth is quite negative, as wages are likely to lag for many months and even quarters.

What about interest rates? Could rising budget deficits lead to higher rates?

To answer this question, we need to draw a sharp distinction between nominal and real interest rates. Nominal

interest rates (we concentrate our discussion on risk-free rates) consist of real interest plus a premium that the creditor demands to cover his potential loss of purchasing power. If inflationary expectations rise, the premium demanded will rise, too. Everything else being equal – i.e., real interest rates remaining unchanged – nominal rates will rise by the increase in the premium. If, for example, inflationary expectations over the next 10 years rise to 3% annually from 1.5%, nominal rates will rise by 1.5 percentage points.

*Real* interest rates, on the other hand, are a function of expected economic growth rates, and not, as some may suspect, the size of the budget deficit. In fact, Chart 4, which plots the Congressional Budget Office's biennial 10-year cumulative surplus projections against the yield on 10-year (on-the-run) Treasury Inflation-Indexed Securities (TIIS), shows quite conclusively – and counterintuitively – that budget deficits or surpluses may be of little relevance in determining interest rates. As pointed out by a recent Federal Reserve Bank of St. Louis publication, *National Economic Trends*, “...projections of ever larger budget surpluses from 1997:Q3 to 2001:Q1 were essentially associated with rising real interest rates, not falling rates. From 1997:Q1 to 2000:Q1, the yield on the 10-year TIIS rose from 3.36 percent to 4.23 percent. Since then, 10-year TIIS yields have fallen to just under 2.5 percent, as has the size of the projected cumulative budget surpluses.

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Contributions by Albert D. Friedberg, Vincent DeCaen, Jeremy Fand, Yakov Friedman, and Mary Anastasia O'Grady.

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

"The evidence presented here suggests that changes in the economy's *expected* growth rate greatly affect both projected surpluses and real interest rates. When economic growth is expected to be strong, particularly labor productivity and investment, the return to capital (the real rate of interest) is thus high, as is the growth of taxable incomes (and hence tax receipts). When growth slows, the opposite tends to occur."

Take note that the most important contributor to the fall of long-term rates in nominal instruments over the past 3 years was the near 200 basis point fall in real rates. This can readily be gauged by the fact that "break-evens" (a measure of inflationary expectations calculated by subtracting yields on real rate bonds from yields on nominal bonds of similar maturities) have remained bounded in a small range (Chart 5).

There are two important implications for TIIS. First, actual static yields, made up of the coupon plus a linkage to

the monthly readings of the Consumer Price Index, should better those offered in nominal securities, if, as we expect, inflation exceeds expectations. Second, and perhaps more importantly, since in our opinion expectations for real economic growth will continue to be scaled down for the foreseeable future, real rates of interest should continue to fall. This should enhance the investment returns of TIIS over and above the relatively attractive static yields mentioned earlier.

In sum, the current environment is providing interesting investment opportunities. Commodity prices, led by gold and energy prices, look certain to extend their spectacular run. Fundamentalists, concerned with specific supply and demand analysis, risk missing the boat, unaware of a growing buying psychosis triggered by war concerns (and perhaps also the miserable performance of paper assets) but nourished by years of loose monetary policy and a dramatic turnaround in fiscal balance. At the same time, stagflation prospects are almost certain to lead to lower real rates of interest and the continued appreciation of indexed-linked bonds.

Chart 1 - CRB Index and diffusion index based on its components

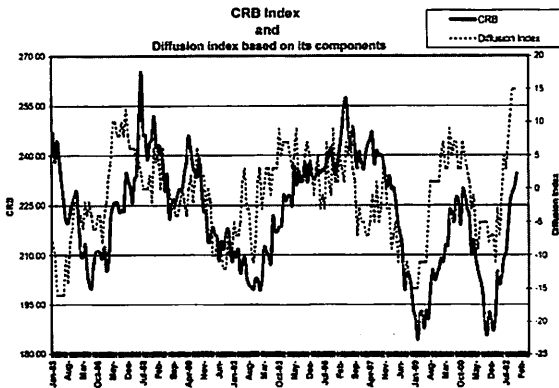


Chart 3 - US Treasury yield spread, 30y-10y

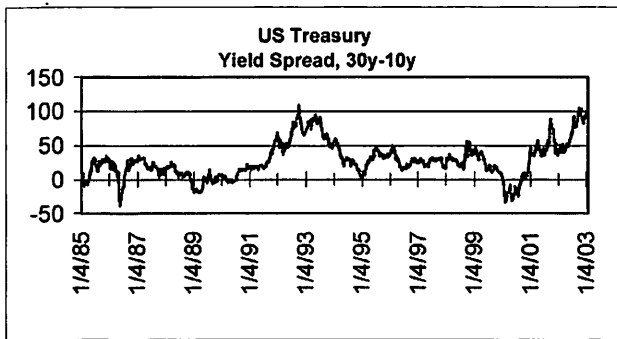
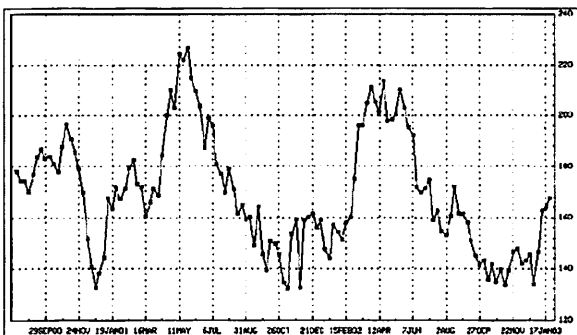


Chart 5 - Breakeven, TII 4-1/4%, 01/15/10 vs. T 5-3/4%, 08/15/10



Courtesy Bloomberg

Chart 2 - US M2 year-over-year

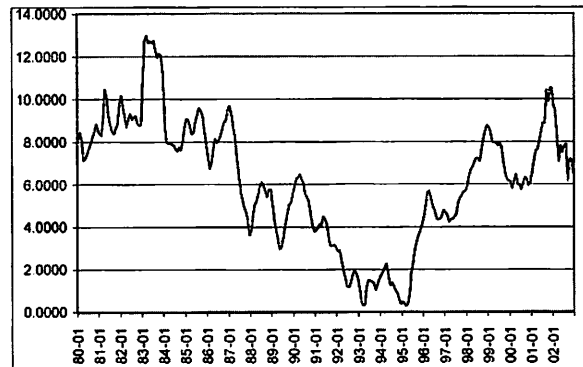
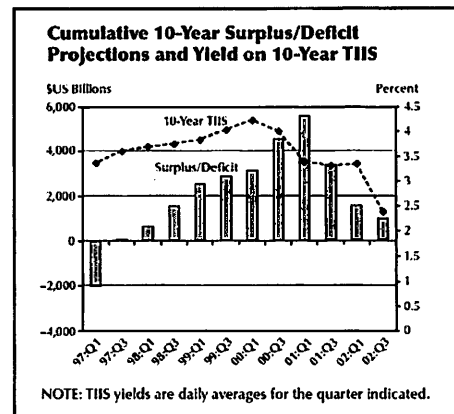


Chart 4 - Cumulative 10-Year Surplus/Deficit



Courtesy National Economic Trends (Federal Reserve Bank of St. Louis) December 2002

**FOREX****Taking the score on flows***By Jeremy Fand*

Currency markets have been dominated by one big story of late – the falling US dollar. While it is hard to pinpoint one specific reason for the fall, the true explanation revolves around the issue of financing the large US current account deficit. In recent weeks, this issue has worn the mask of war fears as the growing opposition to a US-led war on Iraq has kept global investors away from US assets. Over the past few months, this issue had worn the mask of deflation, growth fears, and US dollar policy concerns. It is the lack of investment flows into the US, however, that is the real story behind US dollar weakness in the past year – especially the acute weakness of late.

With an eye on the current account issue, the foreign exchange market has become very interested in tracking investment flows as a way of forecasting forex rates. Official government data, however, are at least a few months old and do not give a real-time read on these flows. Forex dealers have thus been publishing reports of the shorter-term flows that they see, hoping to give a hint as to the trend of the US dollar. There is good logic behind this effort, because the US needs to see about US\$1.5 billion of inflows a day simply to maintain the current account deficit. The declining dollar is a sign that these flows have not been maintained.

To understand better the flow data, the current account must be understood.

The US current account deficit is the counterpart of a net inflow of foreign capital that represents a source of saving to help finance US domestic investment. To finance the US current account deficit, net private capital needs to flow into the US at that \$1.5 billion-a-day pace.

Over the past decade, the US current account deficit grew dramatically. The growth of that deficit in the '90s, however, did not cause a problem for the US dollar. Indeed, it seemed very easy to get the large advances from the rest of the world, because the US generally used these investments to boost productivity.

Global investors were so convinced that the future non-inflationary economic growth rate of the US would continue (and most critically, the return on their investments would also grow) that money poured in so quickly that the dollar was pushed higher and higher. The productivity and investment booms of the '90s should have enabled the US to pay interest and dividends on these "investments" without enduring a decline in the standard of living.

The productivity data and the stock market boom assured global investors that both the probability of repayment and the return on investment on these advanced funds would be high. The bursting of the bubbles, however, changed that probability. Not only has the decline in the stock market eroded these

investments, but the vulnerability of the US to terrorism after the attacks of September 2001 has also reduced the probability of large returns on investment in the US.

Also of growing concern is how the current account deficit is now being recycled. In the past few years there has been a significant decline in the use of foreign advancements for nonresidential fixed investment. Put simply, the US is using the \$1.5 billion a day from the rest of the world to buy more cars, bigger homes – and now, cruise missiles. The concern is that bigger homes and cars and even cruise missiles are not going to lead to higher productivity growth. So now the foreign investor (or "funder" of the US current account) has a lower probability of positive return on investment. With about 25% of America owned by foreign investors, any flow away from US investments directly hurts the value of the dollar.

What is interesting about today's investment environment is that the alternatives to investing in the US don't look so great. While the declining US stock market is evidence of the decline in expectations of positive US investment returns, declines in other global indexes have matched or exceeded those of the US.

US bonds, on the other hand, have been a very good investment in the past few years – again not warranting a wholesale evacuation from US investment. The problem, however, is that the US still needs that \$1.5 billion a day to keep the US dollar afloat, and that has been hard to maintain in the current uncertain investment environment.

While the US is expected to outperform the rest of the G7 on economic growth, the economic outlook is unclear. The risk of deflation or a simple continuation of the depressing effects of the bursting of the post-'90s bubble seems to be enough to prevent that critical foreign investment from coming to the US. The official evidence of this goes a long way towards explaining the US dollar's current problems.

Of particular concern is that purchases of US securities have fallen a dramatic 35% year-over-year, according to the latest US data. (Chart 6 illustrates how net private capital flows fell in the past two years and hurt the dollar.) The net capital flow is calculated as a 12-month moving average of net foreign purchases of US agency bonds, corporate bonds, and equities. Chart 7 shows the modified basic balance calculated as the net private capital flows less the US trade deficit. In both charts the depressive effect on the dollar is obvious.

While the official government data are already illustrating the lack of cross-border investment-flow support for the US current account deficit, the shorter-term speculator has turned to the broker-provided flow data to fill in the gap between the official data and real time. Although no one bank is large

enough to see a large portion of the flows, it is assumed that their client activity is representative of broader market trends.

Looking at some of this data does reveal that in the long term, the bank-supplied data do seem to trend in the same direction as the official data. Yet in the short term, it is hard to get reliable trading signals from the data. For example, UBS published weekly equity flow data that have decent long-term correlations to the US dollar. (Chart 8 shows the UBS-recorded net equity flows between the US and Europe versus movements of EURUSD.)

As can be seen in Chart 8, the short-term flows do not necessarily match the movement in the EURUSD exchange rate, but the longer-term trends do appear to get captured. More to the point, UBS notes that in the week ended Jan. 17, it saw the largest net equity investment inflow into the US since October 2001, yet the dollar has fallen relatively hard during and after those flows were recorded.

According to the UBS data, Europe saw equity outflows in six of the past seven weeks, which also does not explain how well the euro has performed. The UBS data do not include bond-flow data or merger-and-acquisition activity and thus show only part of the picture. It is possible that bond flows explained the disconnect, because money was moving out of equities and into higher-yielding European bonds – but those data are not available.

Other banks' data tell similar stories. Goldman Sachs shows charts of the flows that they see (they do not share the data as UBS does), revealing a similar story of net positive US vs. European equity flows, despite a falling US dollar. Goldman Sachs' bond flow charts do tell part of the missing story, because they show that there was a potentially offsetting net positive flow into European bonds vs. the US that does support the rising euro versus the US dollar.

Data from others (like DB and JPM) are equally difficult to read for short-term directional signals, but all do seem to map pretty well to the official data. Other data that are important for completing the flow picture are an accounting of M&A activity. Some banks, such as Goldman Sachs, put together some of the data that they see in their M&A pipeline, but

again, it is difficult to make this data useful in the short term. The Bank for International Settlement has put this data together in such a way that the longer-term trend is clear (Chart 9).

Also interesting to note is that the BIS data (using official government data) illustrate that much of this flow analysis is applicable only to the relationship between the US and Europe (i.e., the EURUSD exchange rate). The BIS charts show that the US/Japan and Europe/Japan data do not appear to have any meaningful correlation to the underlying currency movements.

This analyst and many hedge funds have done a lot of work on trying to make these sell-side flow data reports useful to the investment process. After many attempts at building econometric models and trading systems based on these shorter-term flow reports, the conclusion is that the data do not give a consistent predictive signal for forex trading.

This does not mean, however, that flows do not matter – just that it is difficult to get a complete and accurate picture of the real-time financing of the US current account deficit. The deterioration of the current account and the consequent effect on the dollar is readable as the official data show.

Recent news reports of central banks (Russia and China) diversifying their reserve investments away from the US add further flow pressure to the US dollar in the near term. The news of significant flow trends (such as central bank reserve management or extremely large M&A deals) and a cognizance of the likelihood the current account deficit finding financing (a complicated economic and investment psychology exercise) is likely to remain a key driver of the US dollar.

Current fears of war with Iraq and the declining popularity of the US administration's position are likely to continue to have a negative effect on attracting the required \$1.5 billion+ a day in financing. Concerns about the future of the US economy, the path of the stock markets, and the next moves by the central banks all factor in as well. Simply looking at the latest real-time flows, however, is unlikely to give accurate guidance in predicting the direction of the dollar.

*Jeremy Fand writes a weekly foreign exchange comment for the research section of our Website: [www.friedberg.com](http://www.friedberg.com).*

Chart 6 – USD vs. capital flows

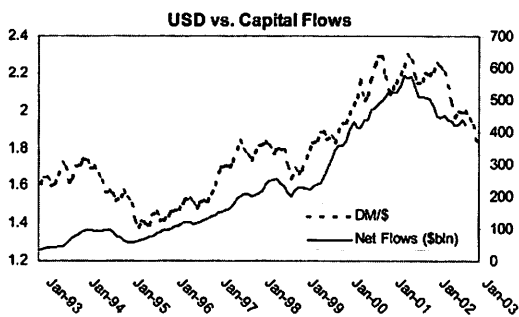


Chart 7 – USD vs. basic balance

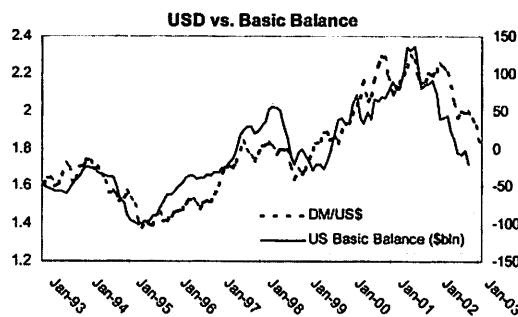


Chart 8 – UBS Equity flow vs EURUSD

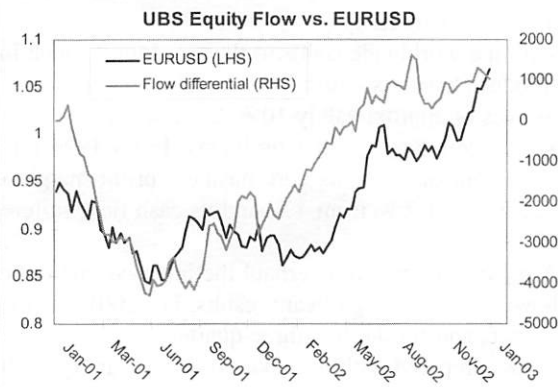
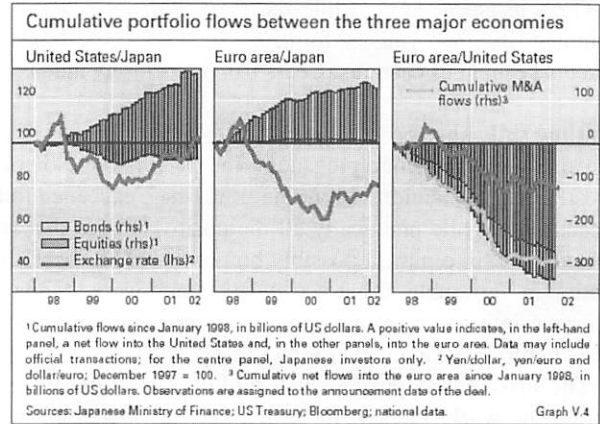


Chart 9 – Cumulative portfolio flows between the three major economies



Courtesy: Bank for International Settlement

**STOCK BEAT**

**Shops, ships and a fresh idea**

*By Yakov Friedman*

**Grocery gains**

In our Dec. 16 issue, we discussed the difficulty investors have in picking the right time to put on a position. Just as difficult is the decision involving when to call it quits. Although it is crucial to have an exit strategy, the continually changing dynamics make it a necessity to reevaluate and update one's plans. A case in point relates to our position in the Great Atlantic & Pacific Tea Company.

As we have documented in the past few articles, we held a short position in the once-great supermarket giant for several months. The Jan. 10, 2003, earnings announcement reinforced our belief that the company has little sense of the direction it is heading. Net operating losses rose above \$1 per share, far surpassing analysts' worst fears. The CEO disclosed that a review of the American operations was underway and that some drastic measures would have to be taken.

It is clear that any vision for the future is cloudy at best and more likely nonexistent. Management has become much more open about the dismal state of affairs, and it is no longer burying the facts deep in the 10Q.

Analysts have come to the realization that intentionally or not, they have been duped into falling for a turnaround story that was 360, not 180, degrees. Most importantly, the market seems to have put a floor on the market capitalization of the company at about \$250 million, perhaps feeling that there would be some residual value in the 700 supermarkets operated by the chain, even if its days as a company were numbered. As the research reports call for even bigger losses and almost all recommendations are to sell, we feel all the bad news is already priced in the market.

We suggest covering the balance of any remaining short position.

**Pharmacy pains**

Walgreen Co.'s first-quarter earnings exceeded our expectations. Our previous gains in the position have been seriously eroded. Still, we remain cautiously optimistic that ultimately this will be a profitable trade.

Net earnings beat estimates by a penny a share. We were troubled with the source of the gains. Comparative pharmacy sales continue to rise at what we believe is an unsustainable pace. The insurance industry is likely to use its sway to rein in runaway pricing. More and more customers are sourcing their drugs outside the US. Although legal challenges are being mounted against this growing alternative, it is our feeling that they are likely to prove unsuccessful until the price structure for domestic drugs changes drastically.

Front store comparative sales remain flat to negative. Walgreen's second quarter, historically its most profitable, relies heavily on its holiday sales of non-prescription, high-margin items. With December front-store sales down from the year before, it is clear that the company is not escaping the malaise that has swept over most retailers. Expectations are for the chain to increase the current quarter's profits by close to 15% year over year. Although the company was able to beat expectations in the last reporting period, we think it will be hard pressed to do so again.

Additionally, we continue to be troubled by what we would term the lack of disclosure by the company. Its latest 10Q filing did contain a section that outlined its heavy operating lease commitments that we outlined in a previous column. Still, the substitution of a prerecorded message in place of the standard analyst conference call makes us wonder why the company refuses to be more open. The apparent glossing over the persistent decline of front-store sales issue continues to

bother us.

On a technical level, while the stock has not broken its downtrend, its improving performance relative to the broader market is keeping us cautious (Chart 10). Stay closely tuned.

### Frontline sails ahead

On a much more encouraging note, the performance of our newest recommendation, Frontline Ltd., has exceeded our expectations. While practically all the positive forces that we outlined came into play, a possibly bigger factor has been the situation in Venezuela. What was once a small work stoppage has grown into an event that has caused long-lasting damage to the country's oil industry.

The strike has stopped about 2 million barrels of oil from entering the world market. In turn, Opec has increased production from other sources in the Middle East. The increased shipping time involved has added pressure to an already hot tanker market. The sudden surge in rates pushed up the market value of all players in the industry. As we previously pointed out, Frontline's extreme exposure to the spot market made it the greatest beneficiary of the change in sentiment.

We believe that the tanker market will benefit from the fallout from the Venezuelan unrest for some time. Even if a resolution is reached soon, there will be long-lasting damage to Venezuela's oil-producing capabilities. Any reaction to news of possible Venezuelan settlements should create an opportunity to add to the position.

Even as the shares trade closer (70) to what we previously felt was fair value (80-90), we continue to believe that even higher prices are in the offing.

### A fresh pick: Fresh Del Monte Produce

A true value investor is always looking to buy a dollar for 50 cents. Of course, there are no free lunches, and every apparent bargain must be closely analyzed to determine if damaged goods are on sale. When Fresh Del Monte Produce Inc. caught our eye, we were intrigued with the value being offered and set off to find the cause of its stock's discount to its peers.

The company was created when R.J. Reynolds sold the various Del Monte businesses in 1989. It is no longer affiliated with the Del Monte Food Company that recently merged with Heinz. It is in the fresh fruit business specializing in banana and pineapple sales.

### Encouraging improvements

The company's results during the first years after its IPO were disappointing. Since then, many significant improvements have been made. Debt levels have consistently been falling as the improving operations produced good cash flow.

The concentrated product line has been expanded to include more of the higher-margin prepackaged products. Additionally, melons, grapes, and many other fruits have been added to the company's offerings, minimizing its reliance on the pricing of bananas and pineapples. Large swings in these core but volatile markets have historically had significant effects on the company's bottom line. We are impressed with the moves the company has made to

diversify the business. While earnings certainly still will be subject to swings, the magnitude of the moves should be diminished considerably.

With the worldwide rights to the Del Monte name in the fresh produce business, Fresh Del Monte's sales have grown at annual rates of approximately 10%. Excessive costs lay at the root of the company's initial problems. From 1999 through 2000, the company saw its core business profit margin drop significantly, to 1.7 % from 4%, and its cash flow suffered as a result.

A major initiative to overhaul the business and cut costs has, however, shown significant results. For 2001, the margin grew to 5%, and for the first three-quarters of this year, it was over 10% compared with less than 4% last year. Typically in this business, the profits are weighted heavily in the first half of the year. Cash flow from operations was up 25% from the same period in the previous year on a 6% gain in revenues. (Revenue was, and continues to be, enhanced by the lower US dollar versus the euro, which the company receives for a large part of its sales.) Management attributes the improvements to its overhauling of various systems, such as distribution.

The extra cash has been used by the company to pay down its debt, which had at one time been so high that the auditor had substantial doubts that the company could continue as a going concern. The overall debt load, including capital leases, as of the last reporting period, is down 65% from its position a year ago, to just over \$100 million.

The ratio of total liabilities to total assets has dropped over the same period, to 40% from 54%. As a result, interest charges have been reduced by 40% from last year's quarter. Management believes that debt will be entirely wiped out by the end of the next fiscal year.

The company is still evaluating what it will do with the excellent cash flow that it anticipates generating. In January 2001 the company announced that it was starting to pay a modest dividend of \$0.05 per share quarterly, which it has maintained to date. This may be seen as a sign of the direction that the company will take with its growing surplus.

Fresh Del Monte sports an attractive valuation with a price/sales ratio of 0.56 and a price-to-book ratio of 1.55. The stock is currently trading at 6 times trailing earnings, at 4 times operating cash flow, and at just over 5 times free cash flow on trailing four-quarters results. Even if capital expenditure were to double for expansion, it still would be trading at a comfortable seven times free cash flow. In addition to these attractive numbers, it must be noted that the company has beaten the IBES estimate by a good margin for several quarters.

### Concerns

With all these compelling bullish items, the erratic, and frankly poor, performance of the stock over the past few months demands an explanation. In our opinion, a number of factors are weighing on the stock. Careful evaluation of each of them gives us some comfort in staying with our long position, even though it has taken us for a roller coaster of a ride so far.

We have addressed the issue of cyclical earnings to some degree. The company has made strides to expand its product

line and protect itself from the commodity pricing swings. Additionally, although there have been reports of lower banana prices, information supplied by the USDA shows that they have recovered nicely after a short lag in November. Any claims of a significant drop in the banana market are certainly not corroborated by these data.

Another thing that stands out as a potential problem is a number of lawsuits outstanding relating to DBCP use (a pesticide banned in the US). Fresh Del Monte's filings indicate that several suits have been filed against the company in various countries. We are optimistic that these will not have a material effect on the company, because similar suits have already been settled for relatively small amounts, and there is reason to believe that the present cases will be also be resolved.

There is a real issue of jurisdiction relating to where these cases can be heard. A recent Nicaraguan court's decision against a group of defendants in a similar case has been dismissed out of hand by the parties involved, and it is not clear what powers if any the foreign courts will have to enforce judgments. American courts have been hesitant to take on these cases, where the alleged wrongdoing took place in a different country.

As this article is being written, the US Supreme Court is hearing arguments in a related case to determine its eligibility for trial in the US. A similar case saw the prosecutors' petition to have the highest court consider the issue denied. It is not clear why the judges have acquiesced this time. It would be purely speculative to anticipate the justices' decision, but we wonder how interested this Republican-leaning Supreme Court will be in opening a Pandora's box and allowing litigation originating elsewhere to be brought in the US against companies with American connections.

Dole Food Company, which is in the same business as Fresh Del Monte, has also disclosed that it has taken out a reserve of about \$10 million to deal with the lawsuits. Fresh Del Monte has taken a charge for a related environmental case in Hawaii. It has not done so for the other pending pesticide cases, because it apparently feels there is not a strong likelihood that it will encounter charges. This may be a result of either the specific cases that exist or just a more optimistic outlook. Even if we were to assume that Fresh Del Monte would have to take a similar \$10 million charge down the road, it would amount to about only 6% of its net income through the first three quarters of this year. This is a relatively small amount when considering the company's revenues.

Note that if the aforementioned concerns were significant in the stock's behavior, one would expect that similar consequences would result for Dole and Chiquita Brands International Inc., companies in related businesses. Dole has recently been taken private at a price close to 14 times trailing earnings and more than 8 times cash flow. If the past year's results were only a cyclical peak, the new owner has significantly overpaid for the company. Though Dole trades at a slightly lower price-to-sales ratio, we feel this attests to the operational improvements implemented by Fresh Del Monte's new management.

Even as Fresh Del Monte's results were improving by the end of 2001, Chiquita was heading into bankruptcy. The improving environment couldn't save a company that wasn't professionally run. Fresh Del Monte, on the other hand, was in a position to benefit from the upturn in the market and use the extra cash to cut down debt levels and minimize worries about possible future macro weakness.

The last explanation that we have been able to come up with relates to the complicated past of the company. The business was formed when Nabisco spun off various divisions from the conglomerate's holdings. Majority ownership eventually rested with Grupo Empresarial, a Mexican company controlled by banking magnate Carlos Cabal Peniche. When the Mexican government determined that Cabal had committed mass fraud with the banks he led, it took control of the holding company. Subsequently, Lehman Brothers was hired to find a buyer, and the company was ultimately sold to the Abu-Ghazaleh brothers, a family that was involved with Chilean fruit exporting.

Just before the deal was finalized, Eastbrook Ltd., a company that was defrauded by Cabal, claimed that it was entitled to a controlling interest in Fresh Del Monte and tried to block the sale. The matter was resolved in a New York court with the payment of several million dollars to settle all outstanding issues.

For six years, the matter seemed to be put to rest. Inexplicably, late in 2002, two separate lawsuits emerged relating to the transactions. One allegation appears to be a rehashing of the Eastbrook complaint. The other asserts that the sale to the Abu-Ghazaleh family was made at a level below the fair value of the company and involved bribe taking.

There is no denying that the allegations are serious and have significantly contributed to the poor recent performance of the stock. Our analysis, now, leads us to believe that the reaction is overdone.

The timing of the cases is most suspect. Nothing was heard from the plaintiffs as the company struggled. Only after the operations were turned around and began producing significant cash, the suits were launched. It is difficult to determine what the Eastbrook case hopes to achieve after it signed off on a deal several years ago.

Obviously, it is impossible to know whether bribes were involved in the sale. The claim that the valuation of the company was flawed, however, doesn't seem to hold water. News stories filed during the time the company was up for sale estimated the total purchase price, including debt assumed, would run between \$500 and \$800 million. The amount realized was at the low end but within the expected range, nonetheless. There are many factors involved in determining the best purchaser, and price offered is only one of them. It is difficult to envision the courts overturning the sale.

Further, the complaint, though naming Fresh Del Monte as a defendant, asks for the courts to strip the Abu-Ghazaleh family of their holdings in the company and return them to some minority holders of the former company. The Mexican government, the former majority holder, is not named. It is not clear what long-term damage a ruling for the plaintiff, as remote a possibility that

we think that is, could do to the company.

A puzzling aspect to the story is the fact that both these actions were first disclosed by sources other than the company. One analyst, in particular, appears to always be a step ahead of management in her knowledge of impending actions. In both cases, Fresh Del Monte issued firm denials and claimed it would mount a vigorous defense.

Another troublesome sign was the resignation of two long-time board members who joined the board together in 1998. The company did not officially announce the moves, and only a change of names on its Website acknowledged them. The official word from one of the former members was that it had nothing to do with the lawsuits and more to do with other commitments he had. The other one, a brother of President Bush, had resigned from the board of the first member's own company just a few weeks before. It is very plausible that his political connections made it more appropriate for him to move out of these business relationships. All in all, we are somewhat bothered by the abrupt moves and the nondisclosure surrounding them.

The incongruence of good operating results and low valuation with poor stock action force one to wonder if something is not seriously amiss with the company. Fresh Del Monte is valued by the market only slightly above where it was before its problems began. It would certainly appear that it is a significantly bet-

ter company today than it was three years ago. The company has historically traded in close tandem with Dole. The improvements to operations contributed to its share-price premium over Dole (Chart 11). Recent action has seen a return to former levels. We believe that a higher valuation is deserved.

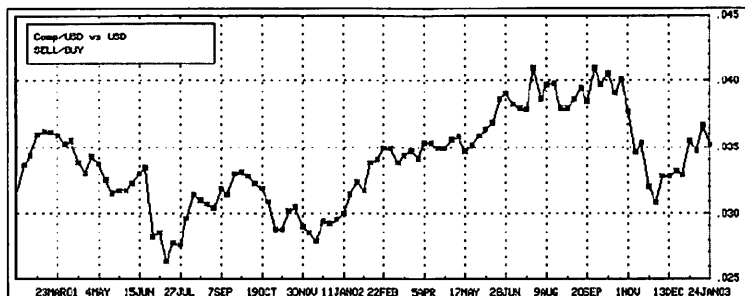
A final point. The market may have been hesitant to add value to a company whose share price had more than quadrupled in 15 months. Shareholders who had seen such large returns in such short a time might have been quick to take profits. We assume that the factors we have discussed are behind the large short interest, which peaked this month at about five times daily volume. But, if we are correct in our assessment, short covering should provide good underlying support.

While we are unhappy with the recent action, the stock has maintained its superior performance relative to the broader market over the longer term (Chart 12). We are hopeful of good times ahead for this apparently still undervalued firm.

Remain firmly long, for now. A move below recent lows of \$17 would force us to reevaluate some of the concerns listed above.

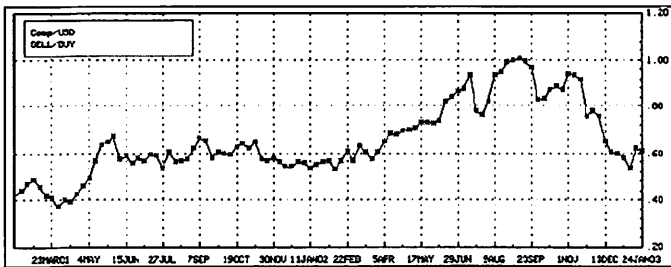
*Yakov Friedman is an analyst with Friedberg Mercantile Group.  
Disclosure: Funds and affiliates managed by Friedberg Mercantile Group own and/or are short securities discussed in this article.*

Chart 10 – Walgreen Co. vs. S&P 500, historical price ratio



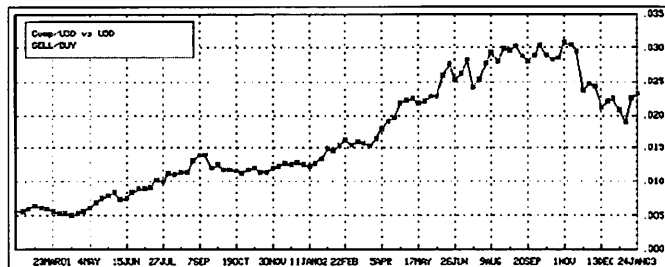
Courtesy Bloomberg

Chart 11 – Fresh Del Monte Produce Inc. vs. Dole Food Company Inc., historical price ratio



Courtesy Bloomberg

Chart 12 – Fresh Del Monte Produce Inc. vs. S&P 500, historical price ratio



Courtesy Bloomberg

**FOREX****Rethinking technical analysis of the forex markets**

By Vincent DeCaen

This column is inspired by the useful survey on forex technical analysis by Christopher Neely, an economist at the Federal Reserve Bank of St. Louis (1997). He concludes his survey as follows.

“Technical analysis is the most widely used trading strategy in the foreign exchange market. Traders stake large positions on their interpretations of patterns of data. Economists have traditionally rejected the claims of technical analysts because of the appealing logic of the efficient markets hypothesis [EMH]. More recently, however, the discovery of profitable technical trading rules and other evidence against efficient markets have led to a rethinking about the importance of institutional features that might justify extrapolative technical analysis such as private information, sequential trading, and central bank intervention, as well as the role of risk.

“The weight of the evidence now suggests that excess returns have been available to technical foreign exchange traders over long periods...” (p. 37).

The goal of this article is to unpack this conclusion. We will consider the three points he makes in the order he follows.

**1. What is technical analysis?**

Technical analysis is a method for identifying profitable short-term trends. The underlying assumption is that history repeats itself because of inherent quirks in human nature. Contrarians have banked on extraordinary popular delusions and the madness of crowds for centuries (Mackay, 2d ed. 1852).

“Human nature” is such a hot topic these days because of the advances of the cognitive revolution and the threats thereof to cherished dogmas. Yet it is surprising how little this revolution has penetrated the economics seminars. (See further, S. Pinker, *The Blank Slate* (2002) for an entertaining and authoritative discussion of human nature and social-science discontents.) Readers may recall that we have already reported on the recent brouhaha over the heresy of Behavioral Finance (DeCaen 2001).

Technical analysis is contrasted with fundamental analysis. Fundamentalists have faith that forex rates have economic determinants. We have reviewed the sorry state of fundamental determination of exchange rates in a suite of notes in this newsletter (22.5, 22.6, 23.1, 23.2; see also Neely and Sarno 2002). Perhaps the nakedness of this emperor may explain why more than 9 in 10 forex traders rely on technical analysis.

Technical analysis can be rendered simple and objective enough to implement computationally; subjective enough to inspire the poet or mystic; or complex enough to gladden the heart of any rocket scientist. Interpreting graphic patterns in

charts appeals to the free-spirit subjectivist (remember watching clouds on a summer’s day?). Iron discipline can be imposed with mathematical techniques such as filtering (to identify breaks in trading ranges) and averaging (the criss-crossing of different moving averages generate buy/sell signals). This is taken up in more detail in the introduction to technical analysis by Martin Pring (3d ed. 1991; now in a 4th edition).

**2. Rejection of technical analysis: the dogma of efficient markets**

Economists are the true believers in our irreligious age. Whereas investors just want to make money, economists must justify the ways of Mammon to man. Economists must also justify corporate and think-tank funding too.

The central tenet of economic theology is *market efficiency*. An efficient market exhaustively and unerringly reflects all information that determines prices. Implicit in this definition is the impossibility of making profits trading on this information. (Implicit also is “hedonistic man” – in Veblen’s terminology: that fiction of Benthamite psychology that rationally maximizes utility.)

Since the late 1960s, we have distinguished three levels of *efficiency*, depending on the distribution of relevant market-moving information. The strongest form of the Efficient Markets Hypothesis assumes an immaculate revelation of all private information: Even the most inside of the insiders cannot profit. Prices therefore follow a *random walk*.

There are weaker versions. The *semi-strong* version allows for insiders and private versus public information. The *weak* version sanctions fundamental analysis but crucially rules out technical analysis. Unexploited trading opportunities cannot persist in any efficient market: Arbitrage should quickly eliminate them. (Notice that in all cases, an efficient market reflects all *publicly available information*.)

And yet, embarrassingly, some apparently prosper. This fact is explained by substituting a *joint hypothesis*. The second part of the substituted hypothesis – i.e., in addition to market efficiency – is that there are no true “profits.” Apparent profits are actually rewards for taking higher risks. These “profits” should, therefore, be really considered *risk premiums*. That’s why futures markets were invented after all: to shift risk from the risk-averse to the risk-takers. (The economics agenda is thus dominated by developing *asset-pricing models* for risk analysis instead of investigating market inefficiencies.)

“But,” say the technical analysts, “we’ve run all the numbers – all the Sharpe this and beta that, etc., etc. – and we see no evidence that we’re taking undue risk. We’re making *risk-free profits!*” (Read: markets are *inefficient*.)

“But,” say the fundamentalists, “you *amateurs* just don’t understand risk and how to measure it. Not like us *professional* economists. Markets *are* efficient. Now go away!”

### 3. Discovery of profitable technical trading rules

Some have tried to document *excess returns* in studies of technical analysis. "Excess" in this context is defined relative to "expected" returns. "Expected" returns can be calculated in a number of ways: We can develop models of pricing assets or simply employ a benchmark (some standard index, e.g., the S&P 500 for stocks) or even look to a "risk-free" return as a baseline (a theoretical interest rate approximated, e.g., by the three-month T-bill). But no matter how we define "expected," the "excess" is consistently over and above the expected return. If the benchmark indicates 5% but we realize a 7% return, we call the difference of 2% the excess return.

*Ex hypothesi*, this excess return is a "risk premium," the reward for holding riskier assets. Economists hope to quantify such "risk" or the higher probability of losses; this risk premium is what a valid asset-pricing model is supposed to correctly generate.

The earliest substantial study on excess returns to forex technical trading is Dooley and Shafer (1983). They implement an array of filter rules for 8 currencies over the first 25 months of floating rates (1973-1981) and find "substantial evidence" of excess returns to the filtering technique.

A "filter" in technical trading has two components. One specification is the percentage change that will generate a buy/sell signal. The second specification is the window, the time period over which the percentage change is to be calculated.

Let us take a concrete example to see how this works, say, a 1% French franc filter (daily). On day one we start comparing our daily FRF rate with previous days. If our rate rises above the lowest previous rate by 1%, we have a "trough" that in turn is interpreted as a buy signal. We then roll over this long position until we spot a "peak" at which the current rate has fallen 1% from the highest value following the trough. Having identified a peak, which we interpret as a sell signal, we square and go short. And so it goes.

Let us annualize the returns to this 1% filter, closing out the account after one year and paying all expenses. This 1%-FRF strategy would have produced a respectable annualized return, e.g., in the year 1975 of 17.31% (their table 3-5, p. 61); however, for that same year 1975, a 20% FRF filter would have shown a loss of -0.90% (it is generally true that the smaller filters outperform the larger).

In general, they do not see the *random walk* predicted by EMH (see above). They employ three tests for inefficiency in total, one of which is the application of the array of filters. Because they are testing a *joint* hypothesis, they attempt to discount the presumed sources of risk. Even so, it is never possible to establish *risk neutrality*, because it is always possible to suggest that they have overlooked something.

Sweeney (1986) claims that the excess profits from technical analysis (filter rules) persist through the 1980s. His statistical method differs only in minor detail from Dooley and Shafer. On the issue of *risk premiums*, he employs a highly technical argument (first paragraph, p. 178) to demonstrate that significant results would call for rejecting the underlying theory of risk assessment. He concludes, "Major exchange

markets showed grave signs of inefficiency..." (p. 178).

More recently, Levich and Thomas (1993) have applied new statistical testing procedures ("bootstrapping") to identify unusually high returns to filtering. They conclude that high returns have remained *positive* and *significant* to date (a total of 15 years) – or in the lingo, they find a "significant degree of serial dependence." (By "serial dependence," we simply mean that the next price in the series is dependent in some fashion on the previous prices in the series: The next price is predictable to some degree.)

(Re: *bootstrapping*. Bootstrapping is more properly *resampling*, a high-powered technique in statistical inference, and a doublecheck against earlier results. In classical stats, you work with a given sample of a population, and your calculations assume an underlying distribution. Bootstrapping sidesteps assuming a distribution as well as allowing you to duplicate that original sample *endlessly* – typically this is some multiple of 1,000 simulated series. Of course you don't actually duplicate anything: Your stats program uses a random generator under the hood to pull out samples of the same size as your sample. The outcomes of thousands of series should form a natural distribution.)

### 4. Conclusion

So we conclude where we began: There does seem to be something about technical analysis – at least the simple techniques that we can easily implement computationally (see further Osler and Chang 1995 for implementing the common head-and-shoulders rule). We are motivated, therefore, to look more closely at the literature.

There is one problem that I see, and this may explain why technical trading isn't more popular: Given sub-periods and given sectors may return *substantial* losses. This approach requires a cold-blooded type of discipline over longer periods than may be possible for many traders. Yet the returns to such discipline seem to be there for the taking.

[I would like to thank Chris Neely for promptly getting back to me with comments on an earlier draft. Of note, he suggests that the resistance to the concept of market inefficiency has been somewhat muted in the last decade or two.]

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## **ARGENTINA**

# After this week, why would anyone trust Argentina?

By Mary Anastasia O'Grady

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On Monday, Argentina announced that it would make a \$680 million loan payment to the InterAmerican Development Bank (IDB) by the Wednesday deadline. But on Wednesday morning, the promise was withdrawn, and Argentina said the decision to make the payment was still under consideration.

A Reuters dispatch Wednesday afternoon reported that Argentina had "told the bank that the payment could not be paid due to technicalities in the central bank charter and said there should only be a brief delay in the payments." But later, Economy Minister Roberto Lavagna said that Argentina would pay up only after it strikes a debt-rollover deal with the International Monetary Fund. Talk about hardball! Argentina, already in default to the World Bank, had stiff-armed yet another multilateral lender as a means of coercing the IMF.

The IDB default was another major breach of trust by a government that already suffers globally from its dismal track record of breaking contracts and going back on its word. Whatever happens to its outstanding multilateral loans, Argentina is doomed to underdeveloped-country mediocrity until it deals with what appears to be a congenital affliction, one that manifests itself in arbitrariness and deliberate rule breaking.

Making the IDB payment on time would have been an indicator of good faith at a time when the IMF was already close to approving the new loan program. But strangely enough, the hardball ploy worked. The IMF, unperturbed at being jerked around by Buenos Aires, said yesterday that the latest default wouldn't affect negotiations, and an agreement on the rollover was expected within 36 hours.

With the IMF under intense scrutiny from critics who say it is too liberal with loans to irresponsible governments, this would seem to be an inappropriate time to advance

financing to a country unwilling to meet its contractual obligations. And all the more so because Argentina has the money to pay the IDB but doesn't want to dip into its international reserves.

Yet, as Argentina undoubtedly understands, if there is a full-blown Argentine default on multilateral debt, IMF member countries will have to eat the losses and IMF bureaucrats will have to formally enter them on the books. This rarely happens at the Fund. The desire to avoid it leaves the IMF caught in a trap: Withhold new lending because a country is unwilling to implement serious reform and you're stuck with a default; or, extend new lending despite a dearth of reform and risk being seen as caving in to blackmail.

The IMF's motives in playing this shabby game are clear. It is in the business of self-preservation. But it remains a mystery why Argentina's top policymakers are not more interested in restoring national integrity. Here you either have the gang that couldn't shoot straight – a totally incompetent government – or one that thinks that its best asset is its ability to game the system.

In Argentine vernacular the latter explanation is called *giveza criolla*. The slick operator may be unethical but cheating gets him ahead. Self-critical Argentines sometimes complain that this mentality is rampant in their society. Certainly it seems to be an operative principle for Argentine governments.

To be sure, the IMF's nonchalance about Argentina's IDB stunt isn't as bad as it might first appear. Any new money the Fund advances to Argentina will only be used to repay loans due to the IMF itself. In terms of Argentina's economic development, it is practically meaningless.

What is more important to the future of the Argentine people is whether they must continue to live with arbitrary and capricious government. It's a government that plays false

with bank depositors by freezing their accounts and forcibly converting dollars into devalued pesos, cheats foreign investors by abrogating their contracts, and wheedles loans from multilateral institutions that it doesn't repay. If Argentina is ever to heal itself, it must adopt some set of rules that the government itself is willing to obey. This may sound simple, but for Argentine governments, with a long history of trampling the law to suit immediate objectives, this would be a radical departure from business as usual.

In a December visit to *The Wall Street Journal* Argentine Secretary of Finance Guillermo Nielsen said that among the government's top priorities is the restoration of credibility to the banking system. It is for that reason, he said, that Argentina was resisting the IMF idea of confiscating deposits and converting them into longer-term bonds. It's still not clear whether Argentina's alternative plan of slowly lifting the banking freeze can work, but Mr. Nielsen's appreciation for the need to restore confidence is a hopeful sign.

However, Mr. Nielsen also said some unsettling things, suggesting a continued preference for dangerous discretion in the hands of policymakers. One revealing comment was in reference to utility contracts, which the government has broken and refuses to restore. "They made a mistake," he said referring to the investors in the utility sector. "They believed that convertibility would last forever, and they made a currency mismatch."

This is a scandalous remark coming from a policymaker who should be defending the rule of law. Convertibility held sway because it was enshrined in law, many contracts were written in dollars, and investments were made under the assumption that the rules would be respected. For the Argentine government to turn around and lay the blame on investors because they trusted in the rule of law is outrageous. It is a message to investors that there is no continuity in Argentina and contracts are meaningless.

Mr. Nielsen also insisted that investors don't care about central bank independence but only about "efficiency." Yet it is clear that had the former government not forced central bank president Pedro Pou out of office in 2001, Argentina's peso crisis might have been averted and responsible bank supervision might have prevailed. It is bizarre to claim, in a country defined by institutional chaos and political heavy-handedness, that the independence of the central bank doesn't matter.

In the coming week, financial press reports will closely monitor IMF-Argentine deliberations. But investors will be looking beyond this game of chicken, which is more about saving face on both sides than it is about economic recovery. To restore investor faith, Argentina will need to persuade the world that it has finally reformed and will henceforth respect contracts and laws. Given the events of this week, that is a tall order indeed.

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