DrobnyGlobalMonitor

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Biases:

EQUITIES:
BONDS: Neutral; ***Formerly Bullish steepeners;**
FX: Bullish Swiss Franc;
EMG: Bullish Asian EMG FX; ***Formerly Bearish EMG Equities**

Current Exposure:

EQUITIES: ***Long Hang Seng Index (Dec 8);**
BONDS: ***Long Dec10 short sterling vs Mar09 (Dec 2);**
FX: ***Long GBP vs USD (Dec 2);**
COMMODS:

Illiquidity, overshooting and reversals

***Please note latest changes to biases and/or exposure**

One of the big surprises this year has been about liquidity. In fact, looking back at 2005 and 2006, when things already looked overdone, excess liquidity was also the story.

Liquidity seemed almost endless, coming from sovereign wealth funds, Mid-east oil producers, and most of the Asian central banks. Of course, as is now very evident, there was a lot of leverage involved in the process as well. And, as all the cash flowed and flowed, it went to all sorts of crazy places and crazy assets. The search for yield and returns led to a wholesale underestimation of credit risk and liquidity risk.

And, the unwind has been brutal. The crisis that emerged in 2008 was a credit crunch more vicious than any of us have seen before. The cold wind of illiquidity hit all sorts of obvious places (MBS, EMG debtor assets). But, it also hit some unexpected ones as well (TIPs, FX forwards, EMG creditor currencies, money market funds, HF and FofF 'gates').

Deleveraging and illiquidity had many effects. They forced down the price of all sorts of assets and created considerable price anomalies. One popular idea is that it makes the battered illiquid assets a buy. That there has been an overshoot relative to underlying value.

Or, there's the relative value idea that credits look exceptionally cheap to things like equities. And, wow, such a trade has worked great in past crises. For example, back in late 2002, the long EMG credit/short equity proved a big winner. (See the discussion at the first ever Drobny Conference in '*Conference Review*, **DGM,** April 29, 2002).

Yet, this time the relative value trade may well not work too. At least not yet.

The severe illiquidity complicated the deleveraging process. Spreads may well have become crazy. But, perhaps not in a way that a simple equilibrium 'value' type analysis might suggest.

In fact, arguably the opposite took place. A holder of an illiquid assets who needed to sell and raise cash often had to compromise by selling a more liquid asset. An imperfect hedge, but sometimes that's all you can do.

So, if you were long an illiquid credit or other asset, you may well have sold equities as a hedge. Or, if you were unable to sell an EMG currency, you may have sold Euro/USD as a proxy.

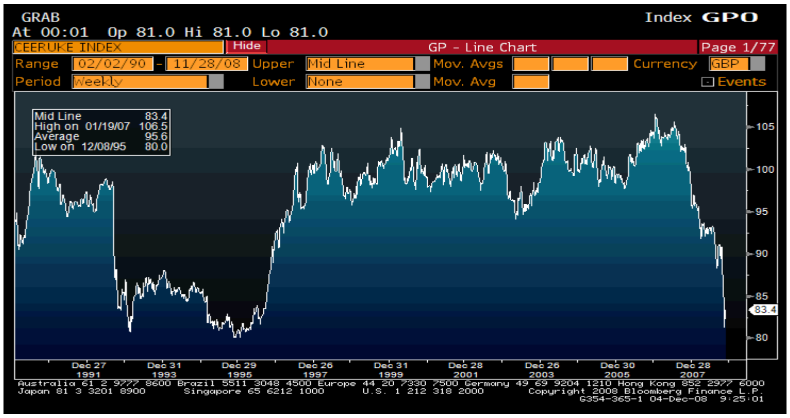
And, this means that over the shorter term, the opposite relative value event may have occurred. It created an unusual short term situation where some of the liquid assets may have overshot to the downside.

That is, the long term 'value' may appear to be with credits and offer all those 'once in a lifetime' opportunities. Yet, the dynamics of the situation create conditions where in the short term the liquid assets overshoot. It is equities that got oversold, and the USD overbought.

This is powerful. It means that, once the possibility of recovery emerges, the reversal in equities and the USD can be fierce. The incentive to hedge becomes less, even if the need to sell the underlying assets remains.

And, the recent big drop in interest rates across the yield curve combined with rising hopes of significant fiscal stimulus next year means those probabilities have started shifting. It is this changed probability that has the potential to prompt a good reversal in those instruments that got battered down during the hedging process.

If this is correct, then the question is which currencies to buy against the USD, and which equity markets to buy. And, there are long term anomalies that have arisen in part due to this short term overshooting idea.



In the currency world, the idea of buying cable still seems solid, though obviously it has so far not worked too well. The idea is simple; the Sterling TWI has crashed, by a good deal more than what occurred in the ERM crash of 1992, which was itself primarily a currency crisis.

The Sterling TWI now looks pretty cheap (above). And, the UK is a key potential beneficiary of any thoughts/hopes that the economic/financial environment isn't getting worse and might actually start to get better at some point next year. It could pop due to an unwind of USD strength and increased hopes for economic recovery.

And equities? Asia seems to scream out on a relative basis. Not just because they've generally gone down the most, though that obviously helps.

But, also because oil and commodity prices are down a lot, which helps Asia disproportionately. And because, unlike in 1997-98, the epicenter of the storm is outside of Asia. The Asian economies have been hit hard, sure, but due to the outlook for exports rather than due to domestic factors.

And, there's China. There is an increased sense that the Chinese authorities are serious about stimulating growth, and this in an economy with already high wage and nominal GNP growth.

China stimulus and much lower oil, combined with a sense that the global downturn may at least be cushioned by recent and impending policy action, seems capable of providing a much improved environment for Asian growth next year. All this suggests this as a decent time and place to stick a toe in with Asian equities (and currencies).

The Chinese equity market thus looks to be in pretty decent shape, given the drop it has experienced. So, too, the KRW, which has been hit disproportionately. USD/KRW seems capable of dropping 10% quickly over the Christmas period, and would still be in an uptrend. If things really do start to look better, then there is little reason why it couldn't recover 20-30%.

But, both of these are relatively illiquid markets. Any trades will need to be relatively small, especially at this point in the year.

So, consider instead the Hang Seng which has also come down a long way in a brief period of time. It offers exposure to China, benefits from a low US and HK rate regime, and could be a big beneficiary in an improved environment in 2009. It is also one of the more liquid equity markets in Asia.

Of course, there are many ways things can still go wrong here. There's still the potential for a default in muni's in the US and some highly levered E European countries. And, the auto issue in the US still does not look to be resolved.

So, it's possible that the HSI purchase will need to be balanced with an S&P short. But, that's not the idea here. If things look better, or at least not that awful, then the unwind from the effects of illiquidity on ***liquid*** instruments could be powerful. And, into the Christmas break, the need for further hedging is likely to be much reduced.

Andres Drobny

Past reports can be accessed at www.drobny.com