DrobnyGlobalMonitor

April 29, 2004

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Biases:

EQUITIES: Bearish; Bearish financials; Bullish TPX, DAX vs SPX;
BONDS: Neutral, Bearish US Corporate Bonds & 10yr JGB vs Bullish 10yr Bunds;
Bearish US Credit spreads;
FX: Neutral USD; Bearish AUD; Bullish Volatility;
EMG:
CMDTY:

Current Exposure:

EQUITIES: Long SPX puts (Mar 3);
Long TPX vs SPX (Feb 20);
BONDS: Pay 10yr US swaps vs long 10yr Treasuries (Jan 28);
FX: ***Long SFr vs GBP (Apr 28);**
Long SFr vs AUD (Mar 10);
Long NOK vs SEK (Feb 26);
EMG: ***Long PLZ vs CZK (Apr 29);**
CMDTY:

2004 Santa Monica Conference Review

Please note latest changes to biases and/or exposure

Two themes dominated this year's conference: anti-carry and commodities. There was a general unease with the state of financial markets right now. The next phase of this amazing experiment, to reflate our way out of the deflationary effects of the post-bubble environment, seems to have commenced. Growth has re-emerged, but in an environment characterized by highly valued assets, a lot of leverage in the system, and with a lot of carry trades seemingly in place. There is thus a danger that rate hikes in the major economies will produce a nasty financial market meltdown. Hence a lot of attention was given to anti-carry type trades.

The commodity theme is in part due to the volatility in these markets, and from some interesting imbalances that have arisen. There are some interesting price laggards (sugar), and some long-term anomalies (in the oil yield curve). There seemed a lot

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of interest in exploiting commodity price volatility either outright or through some neat spread trades.

Perhaps the most interesting outcome was the new distribution of favorite trades in the audience. At the Barcelona 2003 conference in October, the biggest consensus trade was short the USD and long gold. Everything now seems to have changed. The biggest favorite trade was short bonds; with JGB's the largest short by far, followed by Treasuries. Long equities was the next largest favorite trade (with only one short!); led by the Nikkei. But the popularity of this trade lagged far behind the bond short.

Finally, there was very low interest in FX trades. There were a few isolated favorite currency trades out there (UK TWI, BRL vs Euro, TRL), but almost none in the majors. All this seems to confirm suggestions that there has been a major clear out of FX positions out there. Sounds like good opportunities may be coming!

I provide below a review of the 6 trades presented and the subsequent discussions (bios of the speakers are provided at the end of this piece). The occasional comments in brackets [……………] represent my own post-conference comments. Suggestions, amendments, complaints, etc, would all be gratefully received.

1.) Peter Thiel, of Clarium Capital Management, suggested ***buying shares in oil sand companies in Canada, with OPTI as his favorite.*** The idea is to create a synthetic call option on long-term oil. The Canadian oil sand companies are high marginal cost oil producers whose valuation can be explosive if oil were to rise substantially over the next decade.

Both the demand and supply curves for oil are very price inelastic. Global growth is increasingly dependent on the Asians (eg, China), and they are inefficient users of oil. So, demand should be moving up steadily through the next decade. And, there is really no simple or cheap alternative to oil. Rather, he argued, the best alternative product to cheap oil is ***more expensive*** oil! So, when prices go up, demand really doesn't fall much.

But, perhaps it's on the supply side where the biggest dangers lie. The peak in global oil production is near, and reserves may well have been depleted more rapidly than originally thought. US production already peaked and there is increasing evidence that oil reserves have been exaggerated. The OPEC quota system, for example, works by setting production for each country as a percentage of estimated reserves. That creates an incentive to overstate reserves.

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These factors are combining after a 15-year period of low oil prices in real terms. The result is a market mindset that the price of oil will remain in a rough $20-30 per barrel, with occasional spikes. The oil curve is thus still quite inverted, despite a likely trend towards higher prices. The biggest anomaly, therefore, likes in the back months of the oil curve. But, the problem is that the market is pretty thin in precisely the part of the curve you want to get long oil.

Peter's answer is to buy these Canadian oil sands companies that convert tar into oil. ***They are high cost producers, and that's where the beauty of this trade lies.*** They are not that valuable with the price of oil at around current levels. But, their valuation should shoot up if oil prices move higher, and stay higher, than generally expected. At a certain price point, the cash flow of these companies will suddenly surge. So, you get what is essentially a synthetic call on oil prices by owning these companies.

2) Lee Thomas, of PIMCO, broke all the rules of the conference, but generated a lively and useful discussion. Rather than present a favorite trade, he presented a theme: to ***structure a portfolio which protects against a possible meltdown in financial markets.***

It's the anti-carry theme. Lee is concerned about the overall leverage in the system. And, in a world where assets have been inflated by super easy monetary policy, the chances of such a meltdown are high as the authorities try to turn down the interest rate heat.

There were three catalysts Lee identified that threaten danger. The first is higher short rates. The second is if the Asians stop buying US Treasuries. Something similar occurred in the early 1970's when the French stopped supporting the USD and bought gold instead. This event created significant financial market turmoil, and something similar could happen this time around. And, the third risk is further disruption in the Mid-East. Friendly Governments have been placed in an uncomfortable position by the actions of the fundamentalists and the reaction by the US Government. Especially with the legitimacy of some of these regimes under question and with their economic policies of the past 50-75 years having clearly failed.

Lee suggested several hedging ideas, and a vigorous discussion emerged. The idea is to get exposure to tail vol to cover for a nasty big event. The first candidate, it seems, is to ***own equity market puts***. Implieds are real low and the markets have all rallied nicely. It was pointed out, however, that implieds are trading above historicals; ie, actual volatility has been very low, so implieds are actually expensive. Lee's eyes lit up: 'Ahhh, that's the point!' The markets have been stable precisely

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because of low rates and high liquidity provision. And, because the other risks are underestimated. But, when something breaks, it may well be too late to buy the puts! It's a mistake, Lee warned, to take comfort from recent history in the current potentially explosive environment.

This idea was refined during the discussion. One suggestion was to buy puts on US financials rather than the SPX. In any meltdown, these guys are likely to take a disproportionate hit, yet implied vols are running at a pretty small premium to SPX puts (roughly 20% vs 15%). Also suggested was using ***knock-in equity puts.*** This helps subsidize the option, improving the cost-to-payout ratio, and therefore enhancing the hedging potential of the trade. And it fits the idea of trying to capture tail risk.

A second approach is to ***sell the swap spread***. Spreads are very narrow, not just in the US, but especially in Japan and Euroland. The problem with this, it was pointed out, is that it may not work! The swap spread in Japan remained very narrow even when the 1997-98 Asian crisis blew. Moreover, such trades are very capital intensive; you have to carry a substantial position for it to provide sufficient cover.

Another approach is to ***buy low yielding C/A surplus currencies***, especially those recent underperformers. In Asia you've got the Sing$; in N America there's Canada; and in Europe you've got Norway and the Swissie. The latter seems a particularly attractive hedge since SFr-related implied vols are pretty low, offering good exposure should a really nasty meltdown emerge. Or, more generically, ***buy FX vol.*** Crazy things can happen during meltdowns, and FX vol is pretty low.

3) Mark Schulze, of Black River Asset Management, suggested ***buying sugar***. Here you have a multi-purpose commodity (food and a growing fuel substitute), which has been lagging the global commodity price rally. There is a record divergence between sugar prices and some other commodities. The price of corn, a sweetening substitute, is at a 5yr high; yet sugar is near a 20yr low! That places substantial additional demand on sugar as a sweetener, while rallying oil and gas prices places additional demand for sugar as fuel source (ethanol).

And, now some significant supply disruptions have emerged, which leaves the sugar price in a ripe position for a real good catch-up move. The Indian sugar crop is down significantly, which means this former exporter of sugar has suddenly become an importer. The swing is about 5mn tons this year, which is sizeable in a market of around 40mn tons in a year. The EU and Chinese crops are also down; the EU will also become a net importer this year. And, with holding costs of sugar high, inventories are typically very low and can't absorb the likely additional demand.

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Why then, he was asked, is the price of sugar still low? Well, first of all, it's recently jumped up pretty hard from a low hit in February this year [see SB1 on Blmbrg]. So, volatility has suddenly increased pretty sharply, suggesting that this one might well be coiling up for a good move. More important, the prices are currently held down by seasonal factors, especially with the Brazilian harvest coming on stream right now. That is holding back price increases, leaving the market well placed for significant price moves from the summer into the fall.

4) Raoul Pal, of GLG Partners, ***suggested selling US consumer discretionary stocks against the S&P (XLY on Blmbrg).*** The end of the US consumer boom is near, and this sector has outperformed the S&P since late 2000.

He argued that a US slowdown is coming. This is signaled by the ISM New Orders Index, which has been coming down for the last 3 months. For the past 20yrs, this has never failed to foreshadow a peak in the overall ISM index. And, he argued, there is a good contemporaneous correlation between the overall ISM and real consumer expenditure growth.

Moreover, fiscal tightening is on the horizon. This isn't just in some of the states (in California, about $10bn+ of tightening is finally coming, with speculation mounting that it will include tax hikes). The final traunch of the Bush tax cuts will soon pass, leaving federal fiscal policy on a slightly tightening path from here. And, more severe fiscal tightening may be on the agenda after the US election.

This equity spread trade is probably one of the best risk/reward ways to play for a slowing of the US economy. A recent positioning survey suggests that this sector is the most overweighted by mutual funds (7% overweight relative to benchmark). And, the risk/reward of the spread trade is very compelling, with stops pretty close by (3 ½% away), and with pretty good (20%+?) upside potential if the slowdown emerges.

One question from the audience was why not simply buy something like the Dec05 Eurodollar (interest rate) contract if you think a slowdown is coming. The problem with this is that you are in danger of stepping in front of a moving interest rate train in an attempt to anticipate slower growth. And, the US money market curve is actually pretty flat compared to previous up cycles. That suggests the interest rate market is actually anticipating slowdown [and, we were all surprised when it came to a group vote, ***roughly 50% of the audience believed US rates would not be raised at all this year!***]. Going short XLF vs the SPX, in contrast, has well-established risk

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parameters and the market is seemingly leaning the other way. And, it might actually work if rates go up before any slowdown emerges.

5) Saied Simozar, of Bank of America, suggested ***buying SAfrican and Polish bonds.*** Real yields are high in both countries, making the bond markets especially attractive.

Saied's carry-type trades went against the main themes at the conference. The South Africa trade was particularly not well received. He argued that inflation is coming down due to the recent strength of the ZAR, which would enhance the attraction of the bonds. Moreover, with gold up and the currency strong, the central bank was much less likely to raise rates than priced into the market.

Yet, in this anti-carry environment, gold has come down hard. This in turn has prompted a nasty turn in the ZAR, which has become increasingly volatile. Not a good environment for carry. Moreover, without a further appreciation of the ZAR, the recent good run in inflation performance may well be close to, or already at an end. South African bonds, which performed well last year, seem like very high risk instruments in an anti-carry environment.

The Polish trade was better received. Unlike SAfrica, where the currency and the bond market have rallied over the past 12 months, the Polish currency and bond markets have performed terribly. There seems much more value there now that the PLZ has gone down so much on a forward outright basis. The currency is cheap relative to its neighbors, inflation has remained real low, and the competitiveness of the currency is showing up in a pretty good reduction in their trade deficit.

Given all this, why has the Zloty performed so miserably? The problem, it seems, is politics. But, that is now coming to a head, with a political event due next week. So, arguably a lot of this is in the price. [Moreover, Euro/Zloty has been very highly correlated with Euro/USD, but is lagging the move down in Euro/USD.] And, all this politics stuff might well get to a culminating point next week.

One issue that arose was the best liability currency for the trade. And, a great potential candidate is the CZK. The CZK yield curve is sitting almost exactly on top of the Euro curve. Who's more likely to sustain zero real 3mth rates, Euroland or Czechland?? The Czechs have a sizeable trade deficit, and the currency is at uncompetitive levels, especially compared to the PLZ. Long PLZ/CZK is a positive carry trade that might not suffer too much in an anti-carry environment.

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6) And, finally, yours truly suggested ***selling Euro/SFr (currency) and buying Sept04 EuroSfr (interest rate) contract against the Sept04 Euribor contract.*** This is an anti-carry trade with explosive potential.

The Swiss money market curve has been steepening lately, with 50bps of hikes priced into the Sept04 contract. That's similar to what is priced into the US. Yet, the Swiss economy is certainly not as strong as the US economy. Especially with Swissieland's main trading partner, Euroland, still pretty weak. It seems unlikely the Swiss economy can grow strongly without Euroland joining in.

And, what happens if this is all wrong, and the SNB tighten by more than priced into the forwards? Well, first of all, it seems unlikely that the ECB would be in a position to cut rates in such an environment. And, while the Swiss money market curve has been steepening, the Euroland curve remains flat, flat, flat. SNB rate hike fears have combined with ECB rate cutting hopes to produce a rather unusual widening in the Swiss/Euroland expected rate differential. So, against a long Sept04 EuroSfr (interest rate) contract, you sell the Sept04 Euribor contract.

Secondly, a surprisingly aggressive rate hikes by the SNB would probably generate a good move into the Swissie. Euro/SFr could move down a long way in such circumstances. So, against the interest rate spread trade, you sell Euro/SFr. ***Essentially, the combined trade leaves you short Euro/SFr 6mths forward.***

And, finally, a surprisingly aggressive rate move by the SNB could add to global financial market instability. Because the Swissie is a major liability currency and thus major source of global liquidity, SNB rate hikes could add to the current anti-carry environment. That in turn, would enhance the appeal of the Swissie, adding to the potential for further big move down in Euro/SFr.

Please remember that this review is my own interpretation of the proceedings and events. I apologize if I did not give justice to any or all of the ideas and trades present.

And, please send me your own comments on the proceedings. I would be happy to share them in a future piece, or publish it as part of our Guest Piece Programme. And, of course, please get in touch if you are interested in presenting a trade idea at one of our future conferences.

We want to encourage the sharing of ideas. And, to add an extra little incentive, we introduced ***Drobny Awards*** at the conference. The recipients were:

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Best Trade Presented at a DrobnyConference :

Steve Gregornik of Arlington Hill Asset Management, presented at Santa Monica 2003. There have been several outstanding home run trades presented in our conferences (measured as performance in the subsequent 6 months), but Steve's was a classic. He exploited narrow spreads between muni bonds and T-bonds, and an anomaly in the repo mks, to build a positive carry way to be short US interest rates. The timing was pretty precise and, because of the positive carry, one could ride out a bull run in bonds during May03 before the big sell-off emerged. Big gains were recorded with this unusual and precise idea.

Best Guest Piece:

Paul Schulte, Big Sky Capital, suggested buying Asian property vs US property (financials) in October 2003. This trade was a variant of the buy Asian equities/sell US idea but with an additional kicker due to the differential performance in their respective property markets over the past 5 or so years. It was a nice and simple idea, exploited by several members of our circle. It proved a huge home run.

Best Contribution from the Audience at a DrobnyConference:

Raoul Pal, of GLG Partners argued a bullish case for T-bonds against an overwhelming bearish majority at the Barcelona 2003 conference. Particularly interesting, and a real hoot for all to watch, was a very intense debate he had with a prestigious and highly admired member of the hedge fund community. And, history proved Raoul right, with bond yields at the time near the highs of that particular move, and with powerful positive carry on his side.

That's it! See you all at the next conference for another round of disciplined talk and sharing of trade ideas!

Andres Drobny

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PANEL BIOGRAPHIES

Raoul Pal ~ GLG Partners
Raoul Pal manages the GLG Global Macro Fund for GLG Partners in London. GLG Partners is one of the largest alternative investment managers in Europe, managing over $11bn in assets. Prior to joining GLG at the beginning of 2001, Raoul co-managed the Absolute Return Group at Goldman Sachs within the Equities and Equity Derivative Division in Europe. Raoul graduated from the University Of Plymouth with an honours degree in Economics and Law.

Mark Schulze ~ Black River Asset Management
Mark Schulze is a Managing Director and Senior Portfolio Manager at Black River Asset Management. He presently manages the Macro Discretionary Fund, which was launched June 1, 2003. Prior to launching the Black River macro fund, Mark spent 20 years trading with Cargill in Minneapolis. Mark received his BA in Economics from St Olaf College.

Saied Simozar ~ BofA Capital Management
Saied Simozar is the Managing Director of the Global Interest Rate Strategies group of Banc of America Capital Management (BACAP). As head of global interest rate strategies, Saied manages active interest rate, yield curve, emerging markets and currency strategies across all fixed income portfolios. Prior to joining BACAP in 2001, Saied served as senior global fixed income portfolio manager for Putnam Investments and as portfolio manager and manager of portfolio analytics with DuPont Capital Management. Saied earned a Ph.D. in materials science and engineering from the University of Pennsylvania.

Peter Thiel ~ Clarium Capital Management
Peter Thiel is the founder of Clarium Capital Management, a global macro fund based in San Francisco. Prior to starting Clarium, Peter was the co-founder and CEO of PayPal which was sold to eBay in 2002. Peter has also traded for Credit Suisse Financial Products in New York and London and was a securities lawyer at Sullivan & Cromwell. Peter earned his BA in Philosophy from Stanford University and a JD from Stanford Law School.

Lee R. Thomas III ~ PIMCO
Lee Thomas is a Managing Director & the Chief Global Strategist at Pacific Investment Management Company (PIMCO) in Newport Beach, California. Lee joined PIMCO in 1995 to manage & build the dedicated global bond division, PIMCO Global Advisors. Prior to PIMCO, Lee worked for Investcorp in London, New York and Bahrain from 1989 to 1995. At Investcorp, Lee served as the Treasurer and was a member of the investment committee. From 1981 to 1989, Lee worked in various economic, analyst, trading, structuring and sales roles at Chase, Citibank and Goldman Sachs. Lee received his PhD from Tulane University.

Andres Drobny
Andres Drobny is the founder of Drobny Global Advisors, a financial markets research boutique based in southern California that advises a select group of hedge funds, proprietary traders & global money managers on world markets. Before starting Drobny Global Advisors, Drobny served as Strategist & Proprietary Trader at Credit Suisse First Boston in London & NY and was on the Global Foreign Exchange Management Committee. Previously, Drobny served as Chief Economist & Head of Research for Bankers Trust Company, London. Prior to entering the financial markets, Drobny was an academic economist at the Universities of Cambridge & London and holds a PhD in Economics from King's College Cambridge.

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