Drobny Global Monitor

January 27, 2014

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Biases:

EQUITIES: Bearish Major Country (non peripheral Eurozone) Equities
BONDS:
FX: Bearish Yen
EMG: Bearish Asian EMG interest rates;

Current Exposure:

EQUITIES:
BONDS: Short US 5yr Treasury (Dec 2);
Pay Sweden 2yr swap (Dec 2);
FX: ***Formerly Short USD/MXN;**
Long DXY Index (Jan 9);
****Short Eur vs NOK (Jan 20);***
COMD: ****Short Gold (Jan 27);***

The 1997-98 Analogue, the FED & Trouble Trades

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

Comparisons between the evolving EM story today and the 1997-98 financial crisis popped up over the weekend. The exercise is instructive to consider both the similarities and differences with today.

The 97-98 episode started with Asian EM, as the NJAsian economies were overheating and had built up current account deficits. The previous surge in activity was in part financed by borrowing in Yen, where interest rates had been dragged down close to zero by deflationary pressures in that country. The NJAsian eventually cracked and fell sharply. And, interest rates rose. The Yen was dragged down with them initially but, later in 1998, the Japanese authorities intervened and this eventually produced a complete unwind of the 'Asia Yen carry trade'.

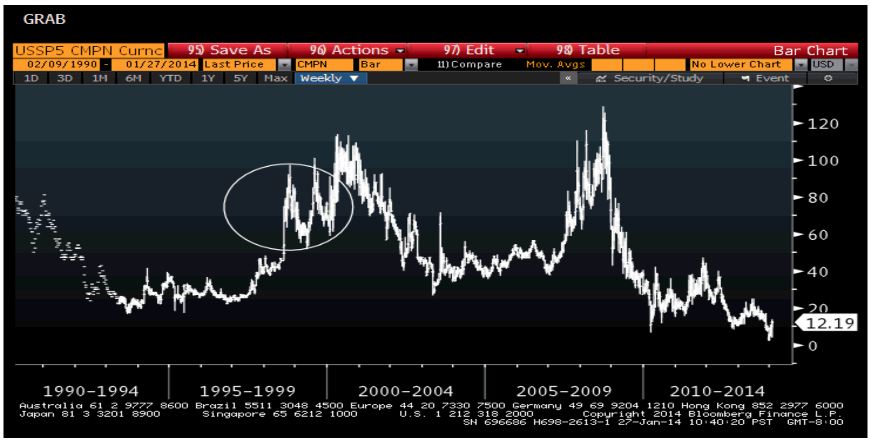
The adjustment down in FX and up in domestic interest rates in NJAsia produced a sharp downturn in the economies, as the rebalancing process began. (This was arguably the beginning of the era of surplus savings throughout Asia (not just Japan) – aka mercantilism – and led to the Breton Woods II system where surplus savings from Asia flowed to finance excess consumption in the US.)

There were several after shocks. The sharp downturn in these rapidly growing oil thirsty countries led to a sharp drop in the price of oil (Brent Crude, 1990-2000 above), though notice how in the early stages the price jumped up first before heading lower! It's not clear in hindsight why that happened, though possibly there was an initial surge in demand from Asia in anticipation of higher domestic prices going forward. Financial contagion, and the drop in oil, led to further reverberations around the world, most notably in Russia in 1998.

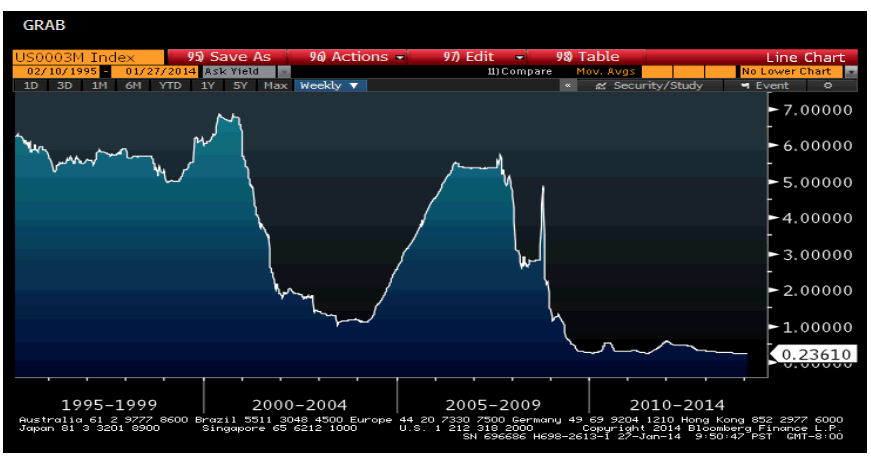
But, also important was what the FED did. Asset market contagion, a growth slowdown and, importantly, the bust of a famous asset manager, led to an easier FED policy. Just at a time when the US economy was growing strongly! It was the birth of the Greenspan put, and helped put in motion the process of serial bubbles we have been involved with over the past 15 or so years.

Today, we again have overheated EM economies, but this time mostly in Europe and Latam. Low DM interest rates fueled a carry trade into many deficit EM countries, which helped fund growing trade deficits. The currencies in many of these countries have been moving lower, and rates are being forced higher which should, over time, produce a rebalancing of those economies. That is, just like in 1997-98, these currencies are going down on a forward outright basis. And, we have the prospect of a sharp slowing, and potential downturn, in many of these economies. There is also the specter of sovereign default in a few particular cases, though the extent to which asset managers may get caught up in this remains unknown at this stage.

All this takes us to the important differences between the 1997-98 episode and today. First, we are in the very early stages of the adjustment process. DM equities are near highs after a ferocious run since mid 2011 and credit spreads are exceptionally narrow. If turbulence and potential defaults are coming, then swap spreads in particular look very low. Just look at what happened to them as the 1997-98 process unfolded (US 5yr swap spread overleaf)! They inched up in 1997 and then jumped up in 1998 as the default story emerged. FED easing in 1998 produced an unwind of these tensions (circled area), and a lot of volatility in the swap spread, but not a change of trend.



And, that leads to perhaps the most important difference between today and the 1997-98 episode: the process starts with US rates at exceptionally low levels (3mth US libor below). There is no room for the FED to ease. Nor should they. Adjustment and rebalancing in many of these deficit countries is needed. The question for the FED is whether this adjustment can proceed without creating big dislocations and limiting financial market contagion. But, that should come later, not now.



Ironically, though, it is arguably FED tapering that was the trigger to current circumstances. Despite exceptionally low rates. It was that taper scare in May last year that helped propel the story, it stabilized in the fall when they didn't proceed with taper in September, and then got going again in December when taper actually began. But, this also means that the stronger the US economic rebound, the greater the pressure on EM FX, rates and the economies. US growth is no release.

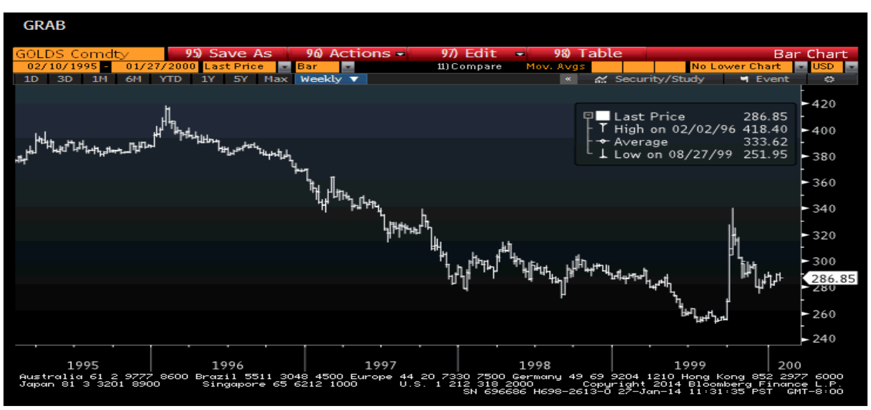
So, a question on some minds is whether the FED blink again, and delay/stall on taper. Even if they taper, they may note the EM problem, raising the prospect of them blinking in the future. That might give hope. And, can help keep some calm early in the week.

Yet, the FED should also have learned something from the past. Stalling/pausing on QE, to support an EMG bubble, or suggesting that they would, would be a mistake. It would send exactly the wrong message. Especially if the US recovery, weather adjusted, is still probably building up steam. In such circumstances, and especially with short rates at zero, a FED blink on tapering would add to potential volatility. Without solving anything. A post FED disappointment trade seems very possible this week as they would gain little by giving a nod to EM at this juncture.

What are the implications? Well, that sounds positive for the USD. And, makes selling gold seem a good target here. It's rallied nicely this year on the US slowdown and into this latest storm. Yet, sustained FED taper, followed by confirmation that the US recovery in on track after the weather hiccup, should renew upward pressure on US rates. All this at a time when EM countries are being forced into rate hikes and with demand for gold from EM countries having apparently slowed down. Falling demand and rising real rates seems a recipe for lower gold.

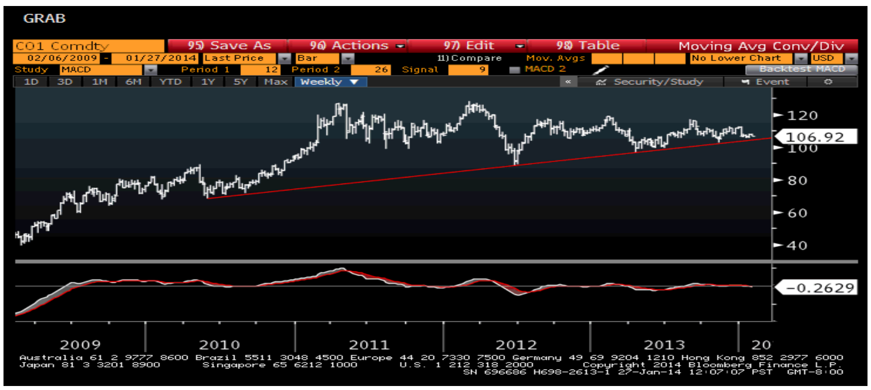
And, that's also what happened in the 1997-98 episodes (below). Admittedly, it was already on a downtrend from early 1996, as a USD bull run had commenced. But, the downtrend accelerated in mid 1997 (again notice the nasty bounce in late 1997, just like with oil). From mid-1997 through to mid 1998 gold went from 340 to a low of 270, before bouncing when FED easing came into play, a 20% drop. From already low levels. Global financial market and economic turbulence is thus not necessarily a gold positive, as is commonly assumed.

Or, go back to oil. This is a different story to 1997-98. The downturn in the Asian tiger economies in 1997 had a direct impact on global oil demand since they were/are a critical marginal (and rather inefficient) consumer of oil. That combined with a rising supply of oil in that period (apparently Iraq



was coming back on stream!) placed considerable downward pressure on the price.

This time around, the turbulence so far comes from a smaller set of countries, so the hit to demand so far is probably negligible. Instead, it's the China slowdown that is a potential major factor, combined with the possibility of increased supply coming from Iran. This has been discussed in these pages recently, and the idea that oil should catch up to the commodity bear market.



Also discussed in these pages is that Brent is trading at support (above), so good sell levels are found either higher or lower than current spot price and not here. But, notice as well that oil vol is trading at around decade lows (below). So, another way to play this is the old tactic of buying delta hedged puts. This gives exposure to the downside in price and upside in vol, but also protection against a bounce off support levels. But, if the 1997-98 analogy has power, there is a sense that the weight on the oil price will be increasing from here, either through reduced demand as turbulence increases and EM economies are forced to retrench, or through a USD rally as FED taper to tightening proceeds.

Andres Drobny *Past reports can be accessed at www.drobnyresearch.com*