# Questions from the Trading Floor

September 16, 2013

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The dominant question on many minds is still whether an unwind in the trends in the USD, US yields and EM equities from the first 8mths of the year has begun to emerge. Regarding EM equities, who better than John Burbank to answer that question; he presented the long DM/short EM equities trade back in April at the Santa Monica Conference (question 1).

Regarding Treasuries, some point to the substantial size of outstanding Treasury and Eurodollar (rate) shorts as shown in CFTC data as indicative of potential for a powerful short covering rally post the FED on Wed. I am suspicious of this idea for several reasons. This data can be an unreliable guide of spec or fast money positions since futures are often used by corporates to hedge underlying positions. That may well be the case here as apparently there has been rate locking activity by corporates recently. Thus what appears as shorts in the data in fact may represent covering of long standing longs in the market. This also fits with the price action, where yields have remained stubbornly high despite a market that is allegedly short. Moreover, the FED policy question has been widely debated and discussed, and it seems much more likely that economic trends, and especially whether the rise in US yields will serve to dampen the recent recovery, will be the key determinant of trends in US markets at least into Q4. - *Andres Drobny*

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*1) After a protracted period of underperformance, EM equities are trying once again to break out on a relative basis. The most impressive fact is that EM equities have their own in USD terms during a period when "taper" fears have been hurting EM FX and fixed income. I think Syria/Taper/German elections all in the price. What do you think?*

Or,

*I think long EM equities could be trade for Q4. Any thoughts on EM equities?*

***John Burbank (Passport Capital)*** kindly provided the following reply this morning:

While the SPX trades up and down on concerns about Syria, the next fed chairman and the back up in rates, EM has had a relief rally the past ten weeks mainly on what hasn't yet happened secularly. I continue to believe that investors should avoid the long-term risks associated with EM, commodities and eventually a greater industrial slowdown in China.

The short term driver of EM weakness was a deficit funding concern due to rising rates in the US pushing rates much higher in EM. Higher rates in EM and higher rate volatility were causing a further slowdown in credit driven growth. This is likely going to work in reverse and expand the PE in the near term as weaker FX has helped the current account in places like Brazil and SA. Based on the USD relationship to SPX/EM, USD weakness has implications for a further squeeze in EM equities vs SPX.

Moreover, the broad recognition by the market that China is not yet choosing to reform its credit growth and centrally planned spending allows for metals and EM equities to rally more on that leadership even if it's not predictive of a multi-year move. In fact, experts in the steel industry believe next year will be quite painful as the ramp up in 2013 will be followed by a broad downward adjustment.

We believe in being long the Chinese consumer and short metals and EM as overall growth slows next year. I believe a top will form in EM this fourth quarter as the market looks past better Chinese data and funding patterns and start discounting again the problems of low quality companies in a weak growth environment that lack Chinese industrialization to create required nominal growth.

*2) I noted your short JGB position and am curious if you have a view on what might be a catalyst for JPY rates to finally start correcting relative to Treasuries. One school of thought is that domestics are propping up the JGB market into half fiscal year end to mitigate the negative P&L on their US Treasury positions.*

That sounds plausible, and fits my timetable. The catalyst I'm looking for is the announcement of the consumption tax question within the next month with what looks like an old fashioned Keynesian tax and spend type policy: the C-tax goes through but is matched initially by increased spending. This, in turn, could lead growth expectations for next year to be revised upwards. And, this would be taking place as the inflation rate is already accelerating quickly.

The other way the T-bond/JGB spread can narrow, of course, is if Treasuries rally on slowing US data. This should send the USD lower as well, and would mean that Yen TWI weakness would likely show up on the crosses rather than against the USD.

This last comment tells me that buying Treasury calls is a very similar risk to buying Yen puts on the crosses……that strikes me as interesting though perhaps obvious to many of you.

*3) I was intrigued by the picture you added to that interesting piece on sterling which showed the similarities between the sterling TWI today and in 1995. What was the catalyst for the sharp sterling rebound that year?*

Global recovery, especially in Europe!! I remember it well. And, as Ben Falk would argue, recovery was accompanied by a strong rebound in productivity (see, *'More Positive Surprises in Store for Sterling'*, Ben Falk, **DG Guest Research,** Sept 12, 2013). Also, regarding pro-cyclical movements in productivity, take a look at the leader article in JPMorgan's *'Data Watch'* for this week. They, too, emphasize the point Ben makes about productivity.

*4) I just returned from the Macro Advisors Conference in Washington DC. Larry Meyer floated the idea of the FOMC lowering the Unemployment threshold to 6% as a way of smoothing the transition to tapering and differentiating more fully the idea of tapering vs rate hikes. What do you think?*

That sounds to me primarily like a bearish USD story and, potentially, a yield curve steepener in the US (as long as the US data does not soften, which would allow the curve to bull flatten but keep the USD on a new downpath).

However, in all the discussions about this topic, I again refer you to this week's JPMorgan *'Data Watch'*, pages 15-18 where they discuss these issues. They make the point that changing the threshold would be very problematic because: (1) it creates the impression that the threshold can easily be adjusted upwards or downwards, which 'would defeat the whole purpose of the threshold as a form of commitment' (p15).

*5) What is the logic for the idea you raise of selling fixed income in countries with flat to inverted money market curves as opposed to other markets? Why those in particular?*

(This question relates to a comment made in *'Tapering, EM, Yen, & Swissie'*, **DGM,** Sept 9, 2013.)

The answer, simply, is risk/reward. In a US-led tightening cycle, what often happens is that other countries become less able to cut rates. If they do cut, they often cut by less than expected and, if they do cut as much as priced in, often the currencies get hit hard as more tightening in the US is expected. I think that's precisely what happened with Eurozone rates this summer, despite people talking about more ECB rate cuts.

The best trade in such circumstances, by the way, is money mkt curve normalization in those countries since, even if they do cut, in conditions of a global economic rebound such cuts increase the potential for growth and thus a future unwind in the cuts. Hence the money market curves can normalize quickly and sharply.

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

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