DrobnyGlobalMonitor

April 4, 2003

100 Wilshire Blvd., Suite 940, Santa Monica, CA 90401 *(310) 440-9819*

Biases:

EQUITIES:	Bearish; Bearish financials; Bullish Japan vs US;
BONDS:	Bullish; Bullish 10yr Bunds;
FX:	Bullish Volatility; Bearish USD; Bullish Euro/Yen;
EMG:	Bullish Lat Am;
CMDTY:	Bullish Precious Metals

Current Exposure:

EQUITIES:	
BONDS:	Long June03 Euribor vs June03 Short Sterling (Feb 27);
	Short US 10yr Swap spread (pay the swap) (Jan 29);
FX:	Short USD vs BRL (Feb 26);
	Long Euro vs SFr (Feb 18);
	Long Euro vs Czech (Feb 13);
EMG:	Short Saudi vs USD 1yr fwd (July 29);
CMDTY:	

DrobnyGlobalConference 2003 Review

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

The focus of the conference was, once again, on a ‘favorite trade’ or favorite ‘trading theme. Six (6) trades or themes were presented, with approximately ¾hr spent on each. The audience was also asked to write down his or her favorite trade. The event was designed to be interactive where everyone plays a role.

It was striking that the trades this year concentrated on specific markets or specific countries rather than on big macro themes. That’s in sharp contrast to last year, where big picture/G3 macro trades dominated the proceedings.

Below is a review of the 6 trades presented and the resulting discussions (bios of the speakers are provided at the end of this piece). Also discussed under item (7) are the results of the survey of attendees. The occasional comments in brackets

[………….] represent my own additional post-conference comments. Comments, replies and corrections would be gratefully received.

1.) Dan Tapiero of SAC and DTAP Capital suggested two trades. The first was to ***sell the NZD against a trade weighted index*** (40% vs Aussie, and 20% each vs G3). His second trade was to ***sell the Euro vs the USD.***

The short Kiwi trade was motivated by a macro-micro concept. This captured an idea that seemed to lie behind many of the trades presented at the Conference this year. We have been witnessing a global macro event over the past few years, with lots of instruments trading in a highly correlated fashion. In such an environment, Tapiero noted, country specific events (eg policy changes) are capable of generating powerful movements in small countries, which are uncorrelated to the general macro environment.

Thus, a popular idea is to buy commodity currencies like the Aussie, Kiwi, and Canadian (see item 7, below). Yet, Tapiero notes that the New Zealand economy has started to soften recently, and a substantial easing of policy may be coming soon [doesn't this not mean that Kiwi bonds are looking increasingly attractive?].

Combine this with C/A deficit of close to 5%, and you get the potential for a nasty unwind of recent Kiwi strength. Not because the commodity currency trade isn't a good one. But, rather, because country specific events make the Kiwi uniquely exposed relative to the other commodity currencies. That's his macro-micro concept.

Tapiero also presented a highly controversial alternative trade: Buy the USD vs the Swissie and the Euro. This was essentially a sentiment-driven and post-Iraq short-term trade with a pretty good stop at the recent USD lows. His idea is that the market is now very short USD's and that a near-term end to the Iraq event should prompt an upward re-assessment of the US economic outlook. Only after such a reassessment, can the downtrend in the USD (and equities) re-emerge.

A lively discussion ensued. The idea that the US economy will rebound post-Iraq similar to what happened after 9/11 was questioned. Another issue raised was the willingness of investors to finance the US C/A deficit without the promise of better returns from US assets. Is Tapiero assuming that US assets will continue to outperform the rest of the world?

Behind many of the comments was the idea that Tapiero may well be right about the short-term USD correction – a relief rally. But, this was seen to take place against a powerful trend. It's a trade that many were willing to miss, with an eye to getting good levels to sell the USD again. These arguments, of course, seemed to add to Tapiero's confidence in the trade!

2.) Jim Leitner of Falcon Fund suggested buying ***indexed linked housing bonds from Iceland.*** Where can you get high real yields in an economy with a budget and trade surplus, an independent central bank, and with inflation and interest rates coming down? Leitner pointed to Iceland, which has been largely neglected by the financial community.

After 5 years of strong growth, the Icelandic economy is cooling fast. The central bank, made independent in 2001, has started cutting rates. The Krona, which depreciated sharply a few years ago, is still pretty competitive despite having recovered by some 15% from the lows. And, a very high trade deficit of a few years ago has been transformed into a surplus. On top of all this is the 'Alcoa Project', where a good deal of capital investment, and capital inflows, are scheduled to begin in the next year or so.

The indexed linked housing bonds yield roughly 5% real, well above the next highest indexed-linked yield offered in the world (New Zealand at below 4%). With inflation at just over 2% and falling, the total yield on these puppies is over 7%, against a short rate of 5.8%.

These bonds are the main liquid bonds circulated in that country, and are guaranteed by the Government. Moreover, there is reasonably good volume to get a trade on, with a total outstanding circulation of $4bn. The main owners and buyers of these bonds are domestics who, Leitner argued, are in pretty healthy financial positions. The risk of forced selling of these bonds seems very small, and upcoming supply should be easily absorbed by domestic funds. So, according to Jim, these bonds offer an excellent yield, a good currency, and you buy something that isn't widely owned by hedge funds and other international financial institutions.

But, the real kicker here, is that these bonds are not yet Euro-clearable. There are, however, changes coming in the next few months, which could well change this status. Such a change would likely push down the yield on these bonds very quickly as European funds add them to their portfolios. And, in the meantime, you earn very nice carry waiting for these events in an economy with excellent fundamentals. In terms of funding the trade, Jim is running it 50% domestically funded (positive carry of 1.5%), and 50% USD funded, with positive carry of 6% and with long Europe vs USD currency risk.

3.) Dwight Anderson of the Tudor and Ospraie funds suggested ***buying US homebuilder stocks.***

The public homebuilders are well-managed, low cost operators with healthy balance sheets, who are gaining market share at the expense of private builders. They typically trade at surprisingly low P/E's, with current valuations trading at a discount to liquidation value. And, much to many participants' surprise, 'liquidation value' was ***not*** based on the current market value for land, but the purchase price of land several years earlier. Potentially inflated land prices do not seem to play a role in these valuations [Does this not differentiate these guys from REITS, where asset valuations are likely inflated?].

Moreover, macro concerns about the outlook for US consumer spending and the housing market has biased the market ***against*** the homebuilders. Anderson pointed out that short interest in these stocks is currently 30% of the float. Yet, the macro concerns relate more to the upper end of the housing market, rather than the 1st time buyer segment, where these homebuilders are concentrated.

This trade naturally generated considerable discussion and debate. Is Anderson arguing that there is no problem with housing on the horizon? Not necessarily, he responded. Rather, his approach is to hedge against this potential by selling other consumer-sensitive stocks against the long homebuilders position. Anderson's team have been using the auto sector as the short. It trades at much higher P/E's, is obviously sensitive to consumer spending, and has all sorts of pension liability problems that the homebuilders do not. A suggested alternative short, whose shares have not already gone down alot, is to use local mortgage providers such as some regional banks.

4.) Steve Gregornik of Arlington Hill Investment Management suggested ***playing for a widening of BMA/LIBOR ratios.*** This is essentially a leveragable basis trade with a limited downside, offering positive carry, ***and*** the potential for capital gains should interest rates rise. A nice combo, though the trade is pretty technical; participants seemed to need a cold cloth to wipe their foreheads as they worked through the details of the trade!!

There were various versions of the trade, but the main idea is to receive 1 or 2yr ratio swaps. You receive a percentage of 1mth LIBOR and pay the BMA rate (repo rate for munis). That earns positive carry, as the BMA rate runs below LIBOR.

The idea is to exploit a very narrow yield spread between tax-exempt US municipal bonds and swaps relative to taxable bonds and swaps. Typically, the spread runs at around 65-70%, which represents a rough equilibrium between taxable and tax-exempt instruments based on tax rates. But, today, with interest rates so low and muni supply high, the spread is up to around 85-90%. The spread should not reach 100%; that serves as a boundary condition.

If rates rise, you benefit from a likely widening of the BMA/LIBOR spread. And, the carry on the trade would increase at each monthly refix of LIBOR. If nothing happens, or rates go lower, you just sit earning the carry, with any capital loss limited by the proximity of the boundary constraint.

One question that arose with this neat little trade concerned credit risk. Does the narrow BMA/LIBOR spread represent a risk of muni defaults? Well, that may be true for longer dated Munis, argued Gregornik, though even here it seems unlikely that yields would rise ***through*** taxable bonds. The 100% ratio boundary should still hold. But, the credit risk with very short dated instruments like BMA's is negligible.

5.) Paul Schulte of Taking Stock, LLC, suggested ***selling the Taiwan equity index.*** This is the Silicon Valley in Asia, he argued, where they have ramped up production and capacity. And, oddly enough, overcapacity is prompting many companies to expand into new product lines to attempt to survive. But, the macro effect is to produce even more price deflation and, ultimately, is likely to prove self-defeating.

On top of this is a great complacency with valuations. According to Schulte, valuations are already very stretched, even without further product price falls. And, Taiwanese corporates he visited recently claimed that price stability is coming soon. That, he argues is very unlikely. The smaller companies in Taiwan are getting crushed by mounting competition from China. This keeps pushing prices of their products, and demand, down. An uncomfortable and potentially dangerous dynamic.

Moreover, the banking system in Taiwan is in a precarious, Japan-style situation. Corporate and now personal defaults are high and rising. And, after big cuts in interest rates, the insurance industry now faces an asset/liability mismatch problem.

All of this suggests that the Taiwanese economy, and especially the stock market, is headed towards a deepening problem. Yet this has not been recognized by domestics, and is not in the price. [These arguments also suggest selling the TWD, perhaps against the Chinese Remimbi].

6.) And, finally, yours truly suggested ***buying the BRL vs the USD, 1yr forward outright (with a short against the Brady 'C' bond as a hedge).***

The trade is motivated by a search for opportunities to sell the USD. And, with the BRL, you have a currency which has already depreciated substantially against the USD and with the forwards predicting a further 20%-plus drop in the BRL. That seems like pretty good odds against a chronically weak and vulnerable USD. Especially since there's been a rather remarkable turnaround in the underlying trade position of Brazil, something that hasn't happened with the US.

The problem with the trade is timing and levels. The USD/BRL has enjoyed a pretty good rally recently. So, what happens if things go wrong?

That's where the hedge comes in. Brady 'C''s are approaching the highs reached in March 2002, when USD/BRL was trading at below 2.40. So, the yield on the 'C's is back down to around 12-13%, while short rates are running around 25%. So, in some sense, the combined trade represents an implicit type of 'yield curve' normalization trade with a long the BRL spot against it. Another way to think about the trade is to ask what would likely happen to Brazilian 'C's if the 1yr forwards on USD/BRL are 'correct'? If USD/BRL were trading at around 4.00 in a year's time, the bet is that the 'C's would be trading a lot lower.

7.) The trades and concerns of conference participants were rather different than last year. Last year, there was a lot of concern about equity markets, and a general ambivalence regarding the USD (equal votes, long and short).

The participants this year concentrated much more on the USD and currency trades. The largest concentration of favorite trades were to sell the USD (11 votes), especially against commodity currencies (five votes) [Mr Tapiero is probably getting more excited now, but he has been warned, last year's audience performed well!]. A variety of cross trades were also suggested, with long Euro/SFr getting the largest number of votes (3).

All sorts of bond trades were suggested, with a slight but not overwhelming balance in favor of bullish trades. The largest amount of votes went for a US flattener trades (3 votes), long US high yield (3), and long Europe either outright (6) or vs the US (2).

Very few equity trades were suggested this year, with longs and shorts equally balanced. And, as with last year, a few participants listed 'long a basket of funds of funds' as their favorite trade.

What would surprise the participants the most? The overwhelming view here was bearish equities. (12) voted that a sustained US equity rally was the least likely event this year, and (7) thought strong global growth was very unlikely. So, although participants seemed unwilling to sell equities, they implicitly seemed willing to sell calls on them. In a similar vein, (6) voted a FED tightening as unlikely, and (5) saw an ECB tightening as very unlikely. Funny, cause the latter view seems so much more obvious than the former.

[Then there were my personal favorites. One vote for least likely event was that 'risk premia return to the mid-1990's levels'. Now, that's an aggressive and seemingly sensible view. But, the best overall combined answer to favorite trade and least likely event was a participant who voted cash as their favorite trade and 'recovery of my tech stock portfolio' as the most unlikely event. Is this individual both very funny, but also a good negative indicator? Or were they once crazy, but have now recovered their senses??]

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 presented.

And, please send me your own comments on the proceedings. I would be happy to share them in a future piece. And, of course, please get in touch with us if you are interested in presenting a trade idea at our next event.

See you all next year for another disciplined round of sharing trade ideas.

Andres Drobny

PANEL BIOGRAPHIES

Dwight Anderson

Dwight Anderson is Investment Manager for the Tudor Basic Industries Group as well as the Ospraie Funds which are advised by that group. Prior to joining Tudor in July 1999, Mr. Anderson was a Managing Director at Tiger Management where he ran the Basic Industries and Commodities Group (10/94 –7/99). Upon completion of his MBA and before joining Tiger, Mr. Anderson was an Associate on the Commodities Desk at J.P. Morgan & Co. (8/94 – 10/94). Dwight holds an MBA from the University of North Carolina (1994) and an BA in History from Princeton University (1989).

James Leitner

Jim Leitner is investment manager of Falcon Family, L.P., a small investment partnership. Falcon Family, L.P. has averaged 36.3% annual returns since inception in 1997. Before founding Falcon, Jim was head of Bankers Trust European Trading and established their Currency Anomaly Fund, which returned 40% per annum under his management. Between Falcon & BT, Jim managed the international macro portfolio for Michael Steinhardt. Jim earned a B.A. degree in Economics with a minor in Russian Studies at Yale University. He also has a MA in International Affairs from Columbia and a JD from Fordham Law School.

Steve Gregornik

Steve Gregornik is a principal and managing member of Arlington Hill Investment Management, a recently formed multi-strategy global fixed income and currency hedge fund. Conrad P. Voldstad the former head of Merrill Lynch Global Debt Markets and Merrill Lynch's representative on the Long Term Capital Management Oversight Committee is the firm's other principal. Prior to founding Arlington Hill, Mr. Gregornik was a founding investor, CFO and VP of Operations of Cognet Semiconductor & Optical Networking until the company's sale to Intel in April 2001 for $200 million. From 1988 to 1999, Mr. Gregornik was at Merrill Lynch where he managed a variety of business units including Global Local Currency Debt trading (1997-1998) and European Fixed Income Derivatives (1991-1997). In 1995, at the age of 28, he was made a Managing Director of the firm, the youngest ever such appointment. Mr. Gregornik graduated from Northwestern University in 1988 where he majored in Economics & Statistics.

Paul Schulte

Paul Schulte is the founder and president of Taking Stock LLC, an financial markets advisory service specializing in emerging market equities. Paul was previously head of equity market strategy for the Emerging Markets group at ING Barings (1996-2000) and head of equity research and strategy for the Far East at CSFB (1991-1996). Before entering the financial markets, Paul was an analyst in the National Security Council in Washington DC under Reagan and worked with the Indonesian Ministry of Finance in Jakarta from 1988-1990 during their financial market deregulation. Paul graduated summa cum laude from the Catholic University of America and holds an MA from the Fletcher School of Law and Diplomacy (Tufts) in International Business and an MA in Political Economy from Catholic University.

Dan Tapiero

Dan Tapiero is founder and CEO of DTAP Capital, a global macro hedge fund that will be opening in June 03. Since January 1999, Dan has been managing an allocation of capital for SAC Capital in Stamford Connecticut. From 1996-1998, Dan managed a macro portfolio for Sofaer Capital, a Hong Kong based global hedge fund. In 1995, Dan was Chief Macro Strategist at Steinhardt Partners and part of a three-man macro team that led the firm's performance. In 1993 & 1994, he was a partner at Argonaut Capital. In 1992 & 1993, Dan was a member of the five-person macro investment team at Tiger Management. Dan graduated Phi Betta Kappa from Brown University with a BA in History in 1990 and also received his MA in History from Brown.

This document is provided solely for informational purposes. It is not intended as an offer to buy or sell any instrument or security nor as advice or recommendation to participate in any particular trading or investment strategy. The content is based on or derived from information generally available to the public from sources believed to be reliable. No representation or warranty, express or implied, is made as to its accuracy or completeness. Past performance should not be taken as an indication or guarantee of future performance and no representation or warranty, express or implied, is made regarding future performance. Opinions expressed in this document may be changed without notice. Previous and future documents may be inconsistent with, and reach different conclusions from, what is presented in this document reflecting changes in assumption, underlying view or analytical method. This document may not be reproduced or redistributed to any other person, in whole or in part, without prior written consent from the author.