DrobnyGlobalMonitor

April 14, 2008

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Biases:

EQUITIES:	Bearish; Bearish financials;
BONDS:	Neutral, Bullish steepeners;
FX:	Bullish Volatility; Bullish Swiss Franc; Bearish Canadian Dollar;
EMG:	Bullish Asian EMG FX; Bearish EMG Equities

Current Exposure:

EQUITIES:	Short Bovespa (Feb 29);
BONDS:	***Long June08 Bund contract (Apr 14);***
FX:	***Formerly Long EUR vs HUF;***
COMMODS:	***Short July09 Copper (Apr 14):***

The Cliff Edge

Please note latest changes to biases and/or exposure

The US economy has so far held up rather well during the housing/financial crisis. It has been flirting with recession. But, as many analysts like to point out, most indicators have suggested 'near-recession' conditions, with no signs of a cumulating downturn. And, with tax rebates coming, the outlook for a recovery is believed to be improving.

But, all this looks set to change. The economy is starting to resemble what it looked like in late 2000. That's when unemployment claims jumped up and the unemployment rate started to rise in earnest. And, then in early 2001, the economy fell off a cliff.

This leaves the US looking poised to experience a sharp drop in activity. In such an environment, the tax rebates might serve to cushion the downturn, but are unlikely to change the trend. Just like with the first tranche of Bush tax cuts in 2001.

If this is correct, then the next phase of this crisis should unfold. We'd switch from a housing and finance story to a more traditional economic one. And, it would likely prove a pretty big surprise, dampening hopes that the worst of this crisis has passed.

A genuine US contraction would enhance the transmission of the crisis to countries abroad, changing the global interest rate story and the outlook for commodities. The ECB would be less able to play things so tough. And, rate hike expectations in other countries should also start to dissipate.

The reason for gloom comes from the US industrial sector, which has held up OK through the housing downturn and associated financial turmoil. But, as the picture above suggests, it looks set to turn down meaningfully.

Especially given the Q1 inventory data showing increased holdings by manufacturers at a time when retail sales have dropped. The result is a jump up in the inventory/sales ratio which, unlike in 2005-2006, looks to reflect unwanted inventory accumulation as retail sales dropped in Q1 (picture below).

The accumulation of manufacturing inventories probably helped hold up activity and GDP in Q1. But, at the expense of activity in Q2 and beyond. And, typically it's when the highly cyclical industrial sector begins to adjust that the biggest multiplier and spill-over effects occur in an economy.

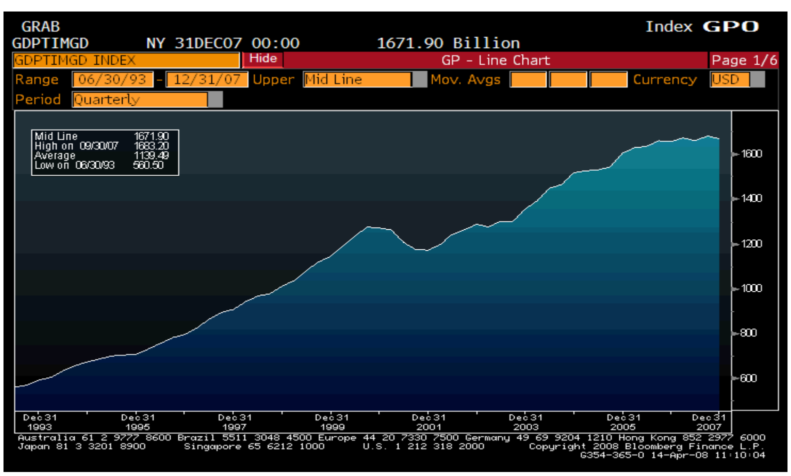
[Why then, has employment already started to give even with industrial production holding up? ***The service sector has been very weak!*** Services tend to be less cyclical and usually hold up pretty well in a downturn. But, not this time. The housing crash has

had a direct effect on mortgage related businesses and other services. Thus, the ISM manufacturing index in Q1 was running around 48.5, roughly where it was in Nov 2000. But, the services ISM has been running far below the upper 50's registered in 2000Q4. Although it has been volatile through Q1, the highest figure for the services ISM was only 52.2 (March). This leaves the overall picture much weaker than in 2000.]

The economic implications of an industrial downturn would be severe. The economy would start to fall off a cliff. Unemployment claims could rise sharply like in early 2001 and the unemployment rate would trend much higher. 80K losses in employment would likely move up to 150's to 200's.

Moreover, remember that the 2001-2003 recession was unusually mild. Monetary stimulus worked after the equity bubble popped, but only by inflating the property bubble and by encouraging increased borrowing and leverage in the US economy. ***The rate cuts in this cycle are instead serving largely to limit the rise in interest rates for credits.*** Just look at the mortgage rate increases in the UK this week after official rates were cut. And, the same seems to be happening in Canada where jumbo mortgage rates have apparently increased sharply recently. And again, the services sector held up reasonably well during the 2001-03 downturn, as is often the case. This seems less likely this time around. If the economy really turns down from here, it could be severe.

But, there's more. A downturn in US industrial production would likely transmit rather quickly, and directly, to the rest of the world. During an inventory correction US imports would finally start to fall. As illustrated in the picture below, import volumes have stopped growing, but have yet to actually fall. And, look at what import volumes did in 2001, during the last big inventory correction in manufacturing! If the US industrial sector turns down, import volumes should fall, and that could hit world trade pretty hard.



So, a US economy falling off a cliff could change a lot of things. We would move from worrying about the financial, to finding new economic trends unfolding.

The Fed would still be in a bind. They still wouldn't really be able to support the USD. But, in a global downturn, the authorities abroad would now be in a position to act. Downward pressure on the USD in an environment of softening global growth could finally translate into rate cuts abroad, or at least fewer rate hikes. Especially if world trade is softening.

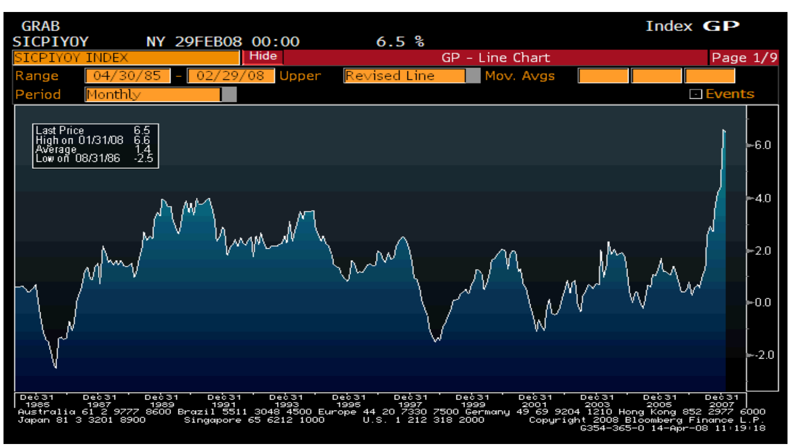
Perhaps not everywhere. One can understand the MAS tightening here……just look at the picture below showing what inflation has done over there! Like many Asian currencies, the SGD is relatively inexpensive and rates are very low.

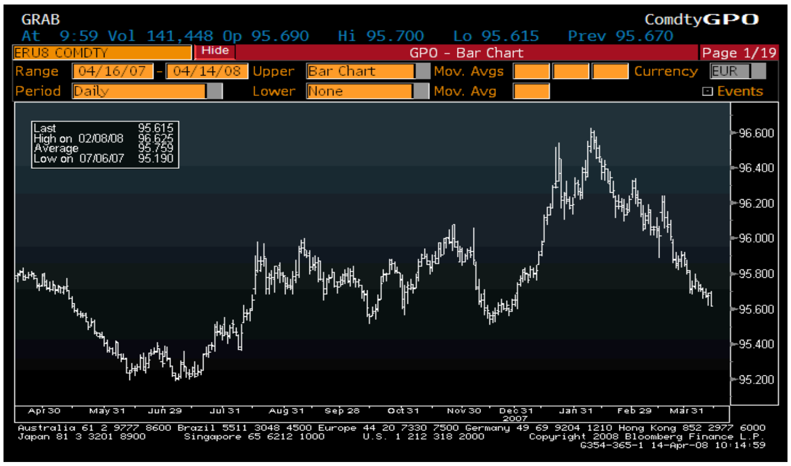
But, how the heck are the Brazilians gonna hike by 250-300bp's that is now priced into that ODF strip if the US economy starts to fall off a cliff? Or, how do the ECB continue playing it tough if global economic conditions start to nose dive? Both have an inflation problem, but nothing like the MAS. It's a different order of magnitude. And, if the global growth picture deteriorates further, the inflation problem itself should become less menacing, especially in the strong currency countries.

What are the market implications of all this? There are several.

First, an economic nose dive could kick off a credit/equity adjustment. There's a growing chorus suggesting some credits are starting to look pretty cheap. Buying them could certainly work, especially if things hold together: if financial system fragility is neutralized and economic growth remains stable.

But, perhaps not if economic conditions deteriorate. So, maybe the next trade will be long credit/short equities. The idea is to selectively buy some credits and use some of the carry to get downside exposure to equities.





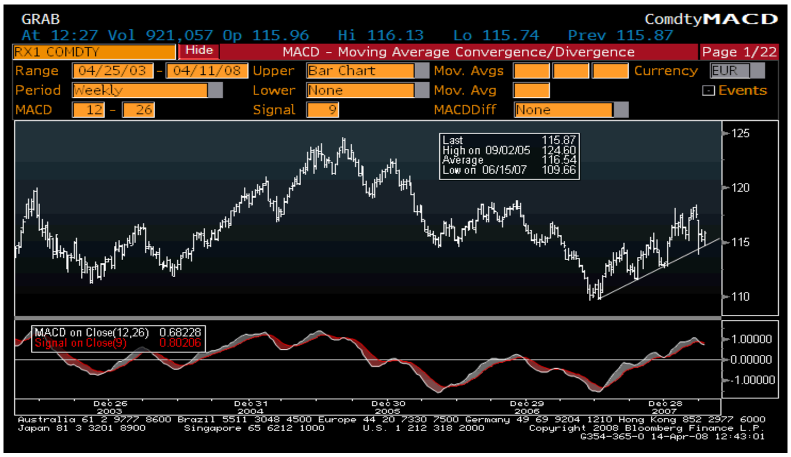
Second, a sudden drop in industrial production may well make long bonds start looking more attractive. Steepeners are very popular and seem well placed in an environment of financial market fragility and with so many inflation dangers around. You know, the 1972-74 scenario when commodity price inflation met easy money, leading to inflation, an eventual ratcheting up in rates, and then an economic crash in late 1974 and into 1975.

That danger remains. But if the idea of a sudden US industrial sector downturn proves correct, then the next twist of this cycle may well be towards a deflation fear. Especially if the downturn in activity were to finally hit commodity prices (see below). In this context, long dated bonds would oddly enough become rather attractive. Both in the US and abroad.

And, that's where long Bunds come in. Now, at first sight, a global economic downturn would make the Euribor curve start looking an interesting buy again. And, as illustrated by the picture of the Dec08 Euribor contract, above, the levels look pretty enticing.

Maybe. But, 3mth libor in Euroland is trading at 4.75% and 1year is also at 4.75%, against an ECB repo rate of 4.0%. So, the ERZ8 contract, at an implied 4.17% already seems to build some easing into the picture. Perhaps not enough, but something.

Now, consider instead the outlook for long Bunds as a global manufacturing downturn emerges. If the ECB stay tough during the initial phases, as seems likely, then that sounds pretty good for the long end. A tough ECB into a downturn means a potentially much improved longer term inflation outlook. And, as shown in the picture of the Bund futures overleaf, the entry level isn't bad and the stop pretty close by. Maybe a bad CPI number out of the US would provide an ideal entry point to this one.

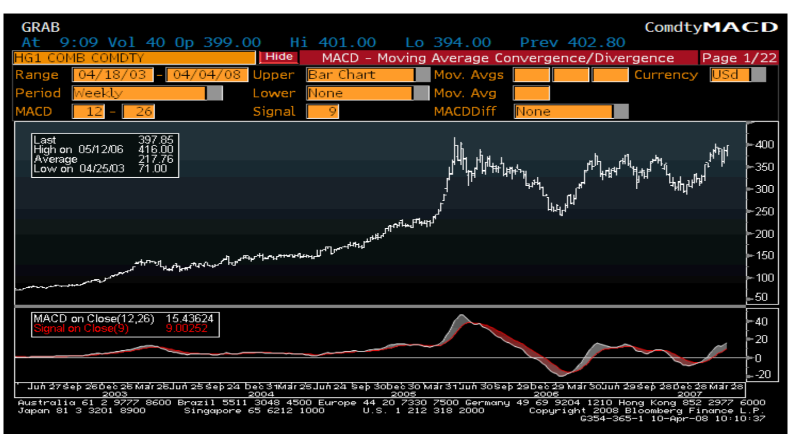


And, if the ECB get friendly fast, then the curve would probably steepen, but the long end should still perform pretty well. The start of an easing cycle? Basically, a sudden lurch downwards in US and global activity should benefit bonds at all yields, and long bonds have been distinctly unpopular given inflation fears.

A third implication is for commodities. A lurch downward in US manufacturing activity, especially if it spreads abroad, might finally dent the commodity price boom.

A nice target here is copper, shown below. It is strongly related to the industrial cycle and is trading near it highs. The recent resilience of global growth, and the idea of decoupling, has probably kept underlying demand for copper surprisingly strong.

But, again, some of this decoupling probably reflects the fact that a manufacturing adjustment has yet to take place in the US. That leaves commodities like copper exposed to a sudden downturn in the US and global industrial production.



Now, what if all of this is wrong? What if, as many seem to believe, that we are witnessing a modest US downturn or mid-cycle slowdown which, given the policy actions coming in the US, means that buying all types of risk (and selling long bonds) is the great Q2 trade?

Well, this might take us back to the SG who suggested that in the Q2 Favorite Trade piece that suggested selling the SFr TWI. They suggested that USD/SFr at 1.00 is 'pure fear and unsustainable' (See, *'Mgr Favorite Trades for 2008 Q2'*, **DGA Views Piece,** April 7, 2008).

That may well eventually be proven correct. But, with US rates below Swissie rates, and with the US economy vulnerable, USD/SFr at 1.00 just doesn't seem so anomalous.

But, what about BRL/SFr, shown above? USD/SFr at 1.00 arguably represents a weak USD and low US rates, rather than the fear factor the SG is thinking about. But, BRL/SFr at 1.70 arguably does! This cross has been treading water since early 2005, despite anomalously high nominal and real rates in Brazil, expectations of even higher rates ahead, and low nominal and real rates in Swissieland.

And, consider the 1yr BRL/SFr forward which, at close to 1.90, is trading near the upper of the little trend lines drawn in. If this cross moves above the forwards and breaks the upper line over the next year, then that sounds like an environment of real trouble where global bond yields, commodities, and/or equities should be coming down. Otherwise, this cross should at worst stay stable, with the juicy possibility of it moving down towards the 1.25 level. It seems a nice hedge against a portfolio geared towards a surprise drop in US industrial activity and more trouble ahead.

Andres Drobny