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Biases:

EQUITIES:	Bearish; Bearish financials; Bullish Japan vs US;
BONDS:	Bullish; Especially US front end.
FX:	Bullish Volatility; Bearish USD; Bearish UK Sterling;
EMG:	Neutral.

Current Exposure:

EQUITIES:	Long Nikkei, short Hang Seng (Mar 26);
BONDS:	Long 10yr Bunds vs Gilts (Mar 20);
FX:	Long Euro vs USD (Mar 14);
	Long Gold (Jan 25);
EMG:	Long USD/HKD 1yr forward (Jan 16).
CMDTY:	Long call on CRB Index/Long Dec03 Eurodollar contract (Feb 15)**.**

DrobnyGlobalConference2002 Review

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

The focus at the conference was a 'favorite trade' or favorite 'trade theme'. There were 5 trades or themes presented. We spent 1hr on each. All attendee's (approx 65) were also asked to write down his or her favorite trade.

I provide below a review of the 5 trades suggested and resulting discussions and debates. Also discussed under item 6 is a review of the results of the survey of favorite trades by attendees. The occasional comments in brackets [….] represent my own additional post-conference comments.

1.) Lee Thomas from PIMCO, Newport Beach CA favorite trade was to ***'buy Junk bonds and sell US equities against it***. A profitless recovery is still a recovery. And, that should be associated with a reduced incident of default.

More deeply, perhaps, the trade captures the concept that this has been primarily an asset price cycle; the economy held up surprisingly well. Yet, an equity meltdown is still a threat, and this may well be the biggest threat to economic stability.

The trade also captures the very low (real) interest rate policy of the FED. It may succeed in holding up equities, but it also generates a search for risky assets. Hence the attraction of junk bonds.

Or, as an alternative, Lee suggested ***buying emerging market bonds against US equities***. This latter trade has the advantage of what he argued is a secular trend towards global convergence. He believes 8-10% bond yields anywhere will soon become unavailable [I presume that means ***real*** and not ***nominal or currency adjusted***].

The discussion centered largely on this latter trade. One problem is that there aren't that many EMG bond markets that look attractive. The Asians are dangerous with the cycle looking to have turned.

Other than Brazil, no one else in South America has much potential, and the dangers of economic contagion are underestimated. [Speaking of Brazil, isn't every EMG fund manager long that one? Sounds potentially dangerous, although of course, the huge EMG long is in Mexico.] So, the EMG trade, it seems, centered on a positive view of Eastern Europe and Russia.

2.) John Cretton, formerly of Ross Capital and now with PPI in Geneva, suggested another EMG-type trade: ***'Buy USD/Sell HKD 2yrs forward'.*** Part of the motivation is that some prominent locals have apparently been seen buying USD's 5yr forward for very sizable amounts.

Behind this is the budget deficit, which is a structural rather than cyclical problem. The property market has been crashing since 1997, and this has resulted in a substantial loss of budgetary revenues at a time when public sector spending has failed to adjust.

A sweeping change in policy is required to address the problem. And, it was argued, raising taxes might actually be tougher to implement politically than a change in the currency regime.

In the ensuing discussion, it was suggested that HK might well move to alter currency policy in the 'next 2-3 yrs', but what they did with it was up to considerable uncertainty. One of the conference panelists suggested they might actually revalue [that sure seems unlikely!]. Or, more likely, they might move to some kind of Sing$ type basket. He suggested that although the risk to the trade was minimal, the potential reward was also not very exciting.

3.) Simon Ogus, of DSGAsia, HK, suggested going ***'long Asia vs the rest of the world'.*** The basic premise was that there is lots of savings in the region. It has a current account surplus and, with excess domestic savings, there was plenty to fuel healthy economic activity and/or asset price appreciation.

There were several ways to express this view. One was in the higher risk countries. He suggested that Malaysian and Indonesian equities looked very attractive, with the currencies enjoying underlying inflows and the market very underweight. And, in the case of Indonesia, 17% rates seemed unlikely to last.

As an alternative, he suggested real assets in the region. Getting exposure to China property looked an excellent trade. Simply consider the effects of nominal income of, say, 7% per annum growth over a 20yr period and you get the trade. There was a discussion as to whether foreigners could actually exploit this trade.

Simon also suggested oil and gas in China. However, he warned against getting involved in Chinese equities; they are simply a funding vehicle for the Government, he argued.

Some of the discussion centered on Korea. The equity market has already had a fabulous run over the past year and there seems to be a consumer credit boom building.

That seems inconsistent with a surplus of savings in the economy. It also implies that rates may well have to go up considerably in that country.

The answer was that Korea has a historic tendency to overshoot. Simon suggested that this could, yet again, prove a boom-to-bust cycle in Korea and expected the Korean equity market to surprise some more on the upside before crashing back down sometime next year. [All this sounds like a currency that has substantial upside; a current account surplus and a high and rising demand for funds.]

4.) Peter Early, Big Sky Capital in Santa Monica CA suggested ***buying 2x2 payer swaptions in Japan.*** This was an old trade, but whose time may well have come. He argued that that paying swaps was a much better trade than that old favorite of selling JGB's.

JGB's are now essentially part of BoJ's balance sheet. They can buy as many as they want. But, interest rate futures will reflect the outlook for economic activity.

And, the outlook may be improving, he argued, since businesses are moving in the right direction. He presented evidence suggesting that capital scrapping in Japan has been taking place pretty aggressively, with a pronounced downtrend in overall capacity since 1998. That, he contended, was the turning point in policy towards bankrupt firms. This has helped remove an obstacle to growth and raised the potential rate of profit in Japan.

Moreover, the risk/reward of the trade is superb. The O/N rate to 2yr spread in the US is something like 150-200bps. In Japan it is under 10bps. For the trade to make money, all you need is for the money market curve to steepen somewhat. You don't need actual rate hikes at all. Moreover, implied volatilities are exceptionally low.

One comment was why not just play the swap spread. Sell the 2yr swaps against JGB's. In a normal recovery, private sector borrowing would increase while Government borrowing should fall.

Other, more skeptical comments concerned instrument choice for a Japan recovery. Sure, the loss in a short the Japan front end is minimal, and the potential gain substantial. Yet, the prospect for higher rates would require genuine signs of a sustained recovery.

These should show up elsewhere. For example the Nikkei. And, although implied swaption vols are real, real low, Nikkei implieds are also pretty low. And, a good pop higher should occur with the Nikkei ahead of any big change in the interest rate outlook.

There was much discussion about whether this time Japan was genuinely set for recovery. Part of the discussion centered on global economic conditions. Peter argued that the current cyclical bounce in global activity gave the Japanese economy a genuine chance to build for a secular recovery. There was a rather vigorous debate on this premise; do the Japanese require a crisis to alter the economic outlook or not?

5.) And, finally, yours truly went for the old fashioned, plain vanilla ***long euro/short USD trade*** was suggested. The argument had 3 elements.

First, that flows had now turned USD negative. The recent sharp reduction in inventories meant that firms had more cash on hand and thus needed to borrow less. There was thus less corporate demand for funds from abroad.

Yet, the US current account deficit remained high. Reduced funding inflows, with the same amount sized deficit in the flow of goods, meant downward pressure on the USD. This, paradoxically, helped explain why the USD remained strong last year; firms still needed to borrow substantial funds in the early phases of the economic downturn.

The second issue is, if the USD is under downward pressure, then what currency do you buy? Drobny suggested the Euro (ugh……). Simply put, unless the Yen registered a strong rally, which seems unlikely, the Euro was the only currency deep enough to absorb substantial downward pressure on the USD.

Moreover, the Euro TWI has been stable for over a year and a half now, with the range narrowing sharply. That set conditions for a potential pop in the Euro.

And, finally, implied volatilities in the currency system were now exceptionally low. With Euro/USD, this reflects the recent narrow trading range, and a generalized lack of conviction regarding the size and direction of a potential move in Euro/USD.

One questioner asked whether it was a short-term trade or long-term trend. I answered that it was both. The USD currently looks vulnerable and the Euro had the potential to surprise. And, over the longer term the USD has a lot of downside potential.

The Euro is the only currency that can absorb a big US downside, I argued. There was an ensuing discussion about alternative asset currencies, with commodity currencies seemingly more popular than the Euro on the asset side.

6.) All conference participants were asked to write down their favorite trade, and what development by the end of the year would surprise them the most. The answers were pretty revealing.

The dispersion in the answers was particularly striking. There doesn't seem to be strong conviction in this cohort.

The largest single answer was long Nikkei, which had a total of only 4 votes. An equal number of people favored a short US equity position.

The second largest (3) votes went to 'short yen' and 'long the US front end'. No one, but no one, expressed a view on the US long end. There doesn't seem to be many positions, or views out there on this one!

There were lots of votes on the USD and the Euro, but they mostly cancelled each other out, with a small net bearish USD/bullish Euro view. Commodity currencies got a mild plus vote. Perhaps surprisingly, two people went for short oil, but this was countered by one long coffee and another long gold. [My favorite of all the trades suggested was 'long a basket of fund of funds!].

What would surprise people the most? Here there was plenty of conviction, especially regarding the US equity market and economic rebound. 10 voted that an equity market rally by the end of the year would be the biggest surprise. Another 8 voted that they would be surprised to see an extended US rebound or a pick up in US inflation.

Please be aware that this review is my own version of the 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. I will be happy to share them in a future piece. Also, please let me know if you would like to present a trade idea at the next conference.

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

Andres Drobny