DrobnyGlobalMonitor

July 27, 2010

3701 Highland Ave, Suite 302, Manhattan Beach, CA 90266 andres@drobny.com *(310) 545-6996*

Biases:

EQUITIES:
BONDS:
FX: ****Formerly Bullish USD***
EMG: Bullish Asian EMG FX;

Current Exposure:

EQUITIES:
BONDS:
FX:

2010 Hong Kong Conference Review

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

Unanticipated Yen strength could be the catalyst for the next twist in the deflationary process. That was the message from the last speaker of the day, who warned darkly that a break down in USD/Yen below, say, the 80 level would prompt widespread defaults in Japan, and could well spread through Asia. This warning is especially interesting since the currency market does not seem braced for this; USD/Yen vol is not that high and the skew is far from recent extremes. A lot of hope seems pinned on the ability of the Japanese authorities to hold up USD/Yen if a real test of their resolve emerges.

This presentation captured the mood of the day, where the talk was dominated by double dips, deflation, and the various problems posed by illiquidity. These concerns were behind some of the panelist trades (buy AUD 10yr bonds, sell USD/Yen). And, they were largely shared by the audience. This showed up in polls throughout the day (see Section 9, questions 11 & 13). And, they also emerged in the rather vehement response to a US curve steepener trade presented towards the end of the day.

Funny, then, that the outcome of an audience poll on T-bond positions at the end of the heated discussion on the curve steepener revealed a modest ***short*** T-bond position (question 14)! And, a reasonable number in the audience chose short yen trades as their favorite (though most of these reflected a bullish KRW/JPY idea, see Section 10). The group seemed well aware of deflationary dangers, but didn't seem to have the positions on. This presumably reflects caution after the big shift in sentiment - and prices – that has taken place over the past 2mths. The consensus sees potential for trouble but seems to be trading on the assumption that things will stabilize for a while.

This was also reflected in a bullish Asia bias of the audience. They were braced for a short term downdraft in Chinese growth, but expected strong growth longer term (Section 9, questions 3 & 4). Most of the bullish equity (and property) favorite trades were Asia oriented. And, once again gold featured as a heavy favorite trade of the audience (Section 10). The other trades presented by the panel included two more currency trades (long USD/CNY vol trade and a currency basket trade), a Bund arb trade, an equity trade (buy Wal-Mart) and a commodity trade (buy Palladium).

I provide below a review of the 8 presentations and the subsequent discussions (bios of the speakers are provided at the end of this piece). The occasional comments in brackets [………] represent my own post-conference comments. Please remember that this is my own review of the proceedings. Suggestions, amendments, complaints, guest pieces, etc, would all be happily received. The more diverse the dialogue, the better!

1) Hugh Hendry of Eclectica Asset Mgmt suggested the short USD/Yen trade. Hugh's theory is that we are one big crisis away from the implementation of policies that will lead us out of the deflation trend. But, until the policy makers learn the hard way, they are unlikely to take sufficiently aggressive action to thwart the deflationary threat. So, he suggested, think of the bleakest outcome to get an appropriate and sufficiently sized policy response. And that, he suggested can come through the damaging effects of a big drop in USD/Yen. He mentioned other possible triggers for a crisis – China growth goes negative, or the Euro area breaks apart. But, those are widely recognized. A yen-generated crisis has not been, at least so far.

That's also his trade. There are good arguments on both sides of the bond trade. Arguably, the same holds with equities or commodities. But, USD/Yen seems to have an almost unique asymmetry. The market tends to be short, the underlying flows are Yen supportive, and the market is not braced for big moves. Until deflationary pressures get resolved, it seems hard to get USD/Yen much higher. But, if it breaks down to new lows, it could run and run and run. And, fuel further deflation.

2) Chris Brodie of Krom River Trading AG made the case for buying Palladium.

This is not as a substitute for fiat currencies but instead due to a structural supply/demand imbalance. The supply curve of palladium is highly inelastic. And, demand has been rising relentlessly, largely reflecting increased global auto production. This creates the potential for an explosive and seemingly inevitable upside to prices. Any global downturn should only delay this eventuality. It's a great trade.

The problem, of course, is that this is partly reflected in price, which means there is considerable downside to any exposure. Look at how far they dropped in the 2008 crisis. Prices have risen strongly over the past year and have are now close to pre-crisis highs, though admittedly they are still well below the peaks achieved in early 2001. But, downside potential limits position size and hence the contribution of a palladium position to portfolio performance for a general macro manager.

A solution suggested at the bar after the event is to buy into palladium mining companies whose valuations are held down by high marginal costs of production. The shares should offer pretty good optionality to the palladium trade.

3) Geoffrey Barker of the BIA Pacific Macro Fund suggested buying 10yr Aussie bonds. These bonds benefit from an asymmetric outlook. 5.1% yields should serve as a magnet in a deflationary environment. But, as long as there isn't a powerful global recovery, Aussie long bonds should benefit from generally tight policy settings which have been ratcheting up through this year. That makes them attractive even after the big bond rally we've just experienced. In fact, the trade is not based on a double dip; you'd probably want front end bonds for that case. But, the long end trade should work pretty well in a muddling through scenario.

There are several kickers benefitting these Aussie bonds. First, policy settings are not just tight, they are actually tighter than they look. The relatively high cost of wholesale funding is highly unusual, with bank depo rates above the bank rate, and is squeezing the banks and bank lending. Added to this is the ending of government guarantees on wholesale funding. Similarly, the fiscal expansion enacted in late 2008 has been running out and fiscal policy is now on a contractionary setting. All this is on top of a stretched household balance sheet and a very strong Aussie dollar.

And, Australia looks particularly exposed to a slowdown in China. But, Geoff was asked, wouldn't a China slowdown lead to reduced commodity demand and a terms of trade shock for Australia? Sure, and that may push down the currency. But, it would also hit the economy hard which has been benefitted greatly from a resources boom. Another participant asked why buy 5% Aussie bonds when you can get 8% on EMG bonds? The answer is liquidity, which allows you to hold far bigger positions in Aussie bonds, and with lower vol.

[This issue came up in a slightly different context at the bar after the event. One participant expressed regret that we did not discuss EMG rates during the day, especially short rates. He argued that, if you want to buy fixed income, EMG is the place to go. One thing to learn from the Greece drama is that developed markets suffer from credit risk. Just like EMG! And, he noted, EMG rates markets traded more like developed markets during the crisis, almost decoupling from currency movements. So, why exactly should there be any risk premium attached to EMG these days? Apart from liquidity issues, I presume. I now wish we had spent some time discussing this. Maybe in London this October. Anyone want to present that type of trade?]

4) Angus Cameron of Komodo Capital Mgmt suggested buying a 12mth straddle in USD/CNY and selling a 3mth straddle against it. This is a cheap way of getting long vol in decent size with the potential to benefit from delta hedging should nothing big on spot happen. The trade exploits the fact that the since 2005 the Chinese currency regime has involved very little spot vol and considerable forward vol. The vol curve is thus too flat.

Angus argued that CNY volatility looks set to increase. Chinese policy used to be oriented to maintaining stability in the rural sector of the economy. A closed capital account and tight control on the currency served that purpose. But, the transition from an export driven economy to one led by domestic demand means the capital account will need to open up. Such a move would release a constraint on domestic interest rates, freeing up monetary policy to respond to the pace of domestic demand growth. The opening up the capital account and freeing up domestic interest rates should help reduce potential economic volatility, but at the expense of allowing higher CNY volatility.

One question was why not just buy outright vol; why do a spread? Well, that depends on what you are trying to capture. The trade is long vol but will also work if, as in the past, spot continues to only grind lower. That's an environment where spot expectations will exhibit a much larger variance than spot itself. Hence, the spread trade is more robust to different policy regimes and is decently scalable.

5) Lee Thomas of Flintrock Global spotted an unusual kink in the intermediate portion of the Bund curve and suggested various trades to exploit this; one is to buy 4yr Bunds 4yrs forward and sell the spot 4yr against it. An alternative is to buy the 4yr swap spread (Bund vs Euro swap).

The anomaly is a very steep bund curve from 4 - 8yrs. Hence, one idea is a flattener trade, where you buy the 8yr and sell the 4yr. This is positive carry trade. And, as an alternative, since the swap curve is normally sloped, the forward swap spreads have very unusual shapes reflecting the kink in the bund curve. The current spot and 10yr forward swap spread curves are inverted, suggesting a perennial crisis in Euroland. Yet, the 4yr forward swap spread is upward sloping and suggests an end to the crisis in about 4yrs time. All very odd, and seemingly exploitable.

Much of the discussion of this trade concerned why the anomaly emerged and persisted. It may have emerged from the combination of high supply and a repo problem. In particular, pension funds don't have a balance sheet to buy bonds outright and so today tend to do things more in swaps because they are balance sheet efficient. And, why is normalization of the Bund curve and swap spreads not occurring? Perhaps because the financial crisis led to a reduction in the number of fixed income arb funds and thus the amount of capital available for this type of trade. That is, the financial crisis has introduced some exploitable market inefficiencies which tend to persist. Lee pointed out, however, that these microstructural factors help explain the general movement of all swap spreads, but not why the 4yr forward was so different from the 5yr and the 3yr (which leads yet another potential arb trade). The main objection to the trade was the length of time the normalization of the 4yr forward anomaly might take.

6) Adam Fisher of Commonwealth Opportunity Capital made the case for buying Wal-Mart. There's been a reach for yield and duration in this disinflationary environment. This process has pulled down long bond yields, leaving buyers of bonds exposed to any sudden reversal in inflationary expectations. Adam suggested considering stocks like Wal-Mart as an alternative 'duration' type instrument. Wal-Mart's value has been relatively stable and held up well in the 2008/09 crash. Yields are decent, as is cash flow. If the disinflationary environment holds, Wal-Mart shares should perform decently. But, unlike bonds, this stock should trade well in a reversal of inflation trends.

One participant accepted that this 'duration' analogy may hold up well in a disinflationary environment, but suggested that it is unlikely to work if outright price deflation breaks out. Wal-Mart stock could get crushed if big trouble re-emerges. Bonds of course wouldn't; they are more of an insurance policy. So his analogy doesn't quite work. Another suggested that the comparison of Wal-Mart yields to nominal bonds is inappropriate. Dividends are essentially inflation proof, so they should be thought of as a rough real yield. The better comparison, then, is with TIPs. Now the real yield on TIPs is generally lower, so that works for this trade. And, Wal-Mart may well outperform TIPs in an inflationary episode. But, notice again that TIPs will outperform Wal-Mart in a deflation, since they are principal guaranteed.

7) George Papamarkakis of North Asset Mgmt suggested a currency basket trade which is long CNY, KRW and NOK and short AUD, BRL and ZAR. This basket is short C/A deficit commodity currencies and long C/A surplus currencies, but pairs 'risk' currencies thus keeping the overall 'risk' profile roughly neutral. The basket has underperformed over the past year as high yielding commodity currencies have received substantial inflows. It offers a positive China bias and should perform well if there is a double dip or an equity market collapse. Slowing growth should reduce the demand for commodities while any financial turbulence would enhance an increasing home bias in banking, thus supporting C/A surplus currencies.

The problem with this trade, it was pointed out, is the substantial negative carry. Even more so if you replace the KRW on the long side of the basket with the lower vol SGD, as one member of the audience suggested. Hence it really is a timing trade, albeit with solid underlying fundamentals.

8) John Brynjolfsson of Armored Wolf LLC made the case for a US steepener trade where you buy the 3-4yr Treasury and sell the 20/30 year against it, duration neutral. Brynjo argued that Bernanke has all the tools and instruments to avoid deflation. So, although he has played things cool and calm recently, the drop in the core inflation rate in the US below 1.0 means he is likely to soon bring out the next installment of quantitative easing; essentially QE2. Brynjo also pointed out that virtually all hyper inflationary periods began during periods of slow growth, not high growth. It is a mistake, therefore, to be buying bonds on a short term slowdown in growth. The recent rally is thus an opportunity, and the forwards price in flattening.

Oh boy, quite a raucous discussion/debate ensued with many issues contested. First, why assume Bernanke can actually change the underlying deleveraging trend? At best he might be able to control the pace of deleveraging, but not the direction. A more extreme question is whether monetary policy has become impotent in an environment where the financial system has become dysfunctional. In such circumstances, it was suggested, base money may increase dramatically but this may not have an effect on broad money. This is a modern version of the old idea of a 'liquidity trap', where monetary policy becomes entirely ineffective and fiscal policy becomes the dominant policy variable influencing the growth and inflation path.

But, perhaps the most telling point in all this, though probably the most narrow in focus, was whether QE2 would be conducted with the FED purchasing longer dated Treasuries rather than shorter dates. Bringing 5yr rates down to 1% would seem to have much less effect on activity than pulling 10yr rates down to 2%. So, even if Brynjo is right about everything else, if he is wrong about where on the curve the FED buys Treasuries his trade may end up well under water! Imagine, after all this, the hilarity after we took an audience poll which revealed a bullish bias to 10yr Treasuries, but a net short position (Section 9, questions 13, 14). It seems many in the audience disagreed with Brynjo's analysis, but thought he may well be proven right in the short term.

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

9) ***Audience Poll Results*** (Questions asked during the Conference)

1) What is your view regarding the yield on 10 year Australian Government Bonds in a years' time?

Below 4%	5	7%
Between 4 and 4.75%	21	28%
Between 4.75% and 5.25%	30	40%
Between 5.25% and 6%	16	21%
Above 6%	3	4%
	Total Votes --75	

2) What is your current positioning in 10yr Australian Government Bonds?

Very long	4	6%
Moderately long	22	31%
Neutral	43	60%
Moderately short	2	3%
Very short	1	1%
	Total Votes --72	

3) What is your view regarding the growth rate of the Chinese economy over the next 12 months?

Above 12%	3	4%
Between 10-12%	8	12%
Between 8-10%	49	73%
Between 6-8%	6	9%
Below 6%	1	1%
	Total Votes --67	

4) What is your view regarding the growth rate of the Chinese economy over the next 6 months?

Above 12%	2	3%
Between 10-12%	8	11%
Between 8-10%	38	52%
Between 6-8%	21	29%
Below 6%	4	5%
	Total Votes --73	

5) What is your view regarding the direction of CNY vs the USD by the end of the year?

More than 8% appreciation	5	7%
Between 5-8% appreciation	14	19%
Between 3-5% appreciation	22	29%
Between 0-3% appreciation	29	39%
USD appreciates against CNY	5	7%
	Total Votes --75	

6) What is your current positioning in CNY/USD?

Very long CNY	10	14%
Moderately long	32	45%
Neutral	26	37%
Moderately short	3	4%
Very short	0	0%
	Total Votes --71	

7) What is your view of the CNY volatility trade presented by Angus Cameron?

Like the trade	27	36%
No view on the trade	36	49%
Dislike the trade	11	15%
	Total Votes --74	

8) What is your current positioning in CNY volatility?

Very long	3	4%
Moderately long	16	23%
No position	44	63%
Moderately short	7	10%
Very short	0	0%
	Total Votes --70	

9) What is your current view regarding the Brazilian Real?

Very bullish	3	4%
Moderately bullish	16	23%
Neutral	19	28%
Moderately bearish	23	33%
Very bearish	8	12%
	Total Votes --69	

10) What is your current positioning in Brazilian Real?

Very long	1	2%
Moderately long	10	17%
No position	41	71%
Moderately short	6	10%
Very short	0	0%
	Total Votes --58	

11) What is your view of the current financial market environment?

Very bullish	0	0%
Moderately bullish	12	19%
Don't Know	16	25%
Moderately bearish	29	45%
Very bearish	7	11%
	Total Votes --64	

12) What is the current risk orientation of your portfolio?

Well above average risk	3	5%
Moderately above average risk	9	14%
Average risk	14	22%
Moderately below average risk	28	44%
Very low risk	10	16%
	Total Votes --64	

13) Where will 10 year US treasury yields be by the end of 2010?

1% or less	3	4%
Between 1-2%	9	13%
Between 2-3%	32	46%
Between 3-4%	26	37%
Above 4%	0	0%
	Total Votes --70	

14) What is your current positioning in 10year US treasury bonds?

Very long	3	6%
Moderately long	11	20%
No position	18	33%
Moderately short	22	41%
Very short	0	0%
	Total Votes --54	

15) What is your current view regarding Gold?

Very bullish	11	17%
Moderately bullish	21	32%
Neutral	11	17%
Moderately bearish	18	27%
Very bearish	5	8%
	Total Votes --66	

16) What is your current positioning in Gold?

Very long	4	7%
Moderately long	16	28%
No position	29	51%
Moderately short	7	12%
Very short	1	2%
	Total Votes --57	

10) ***Summary of Audience Favorite Trades*** (Asked at start of the Conference)

FX: Total: 25

Largest samples:

7 Short Yen (5 vs KRW) - against 1 long Yen
5 Short Euro (1 vs Swissie, 1 as a 1yr 1.00 Euro/USD 1-touch) - against 1 long Euro
2 Long Asian FX vs USD & Euro (1 included GBP in short basket)
2 Long SGD (1 vs INR)

Most interesting/unusual: short EMG FX Vol

Fixed Income Total: 17

Largest samples:

5 Long Front Ends (2xUS, EMG, BRL, 1y1y receivers in developed mkts)
3 Short JGB's
2 Long High Yield (US, Asian)
2 Long 10yr Sov's (AUD, GBP)
1 Long US credit spreads vs Short Euro credit spreads

Most interesting/unusual: Long Tokyo Electric CDS

Commodities Total: 14

Largest samples:

9 Long Gold (1 vs Yen) - against 2 Short Gold
2 Long Ags (1 Corn)

Most interesting/unusual: 12 long vs 2 short

Equities: Total trades: 10 (including EMG equities)

Largest samples:

2 Short S&P
2 Long Bank stocks (Basket of Singapore, HK and Australian Banks; Lloyds Bank)
1 Long Nikkei
1 Long EMG
1 Long Chinese consumer stocks
Short Western equities vs long Asian equities
Long Eurostoxx 50 2013 dividend swap

Most interesting/unusual: Long EJ (ehouse China)

Other Favorite Trades: 5

3 Long Asia property (HK luxury, SE Asian cities, China)
1 Receive INR front ends, short Euro/INR via options
1 Short Risk assets

PANEL BIOGRAPHIES: Hong Kong - 2010

Geoffrey Barker ~ BIA Pacific Macro Fund
Barker has been the Manager of the BIA Pacific Macro Fund since its inception in 2006. Barker has worked as an economist, research director and fund manager covering the Asia Pacific region since 1986. Barker worked initially at Smith New Court in London as an Asia Pacific economist, then at Barings in Tokyo as Chief Economist-Japan and Head of Japan Research, at Schroders in Hong Kong as Chief Economist-Asia Pacific and Head of Asia Pacific Research, and at Dresdner Kleinwort Benson as Head of Asia Pacific Economics and Strategy. From 2000 to 2004 he was the Chief Economist-Asia Pacific, and Head of Asia Pacific Research, with responsibility for all currency, fixed income and equity research, for HSBC. He graduated from Bath University in 1985 with a BSc in Economics and Politics, and then in 1986 from City University Business School in London with an MBA.

Christopher Brodie ~ Krom River
Brodie is the CIO and founder of Krom River, a commodity hedge fund based in Zug, Switzerland. Brodie was a senior portfolio manager and partner at Armajaro Asset Management LLP from March 2004 to December 2006. Brodie worked with John Tilney at Double Eight Limited, as a discretionary trader and with Carlton Asset Management from May 2003 to November 2003, where he was responsible for designing a trading system. He had previously worked at Scottish Power PLC from December 2001 to January 2003 developing trading strategies, implementing options trading and assessing origination deals. Brodie traded his own capital on a discretionary basis from 1996 to 2001. Brodie was an options specialist at

Winchester Commodities from 1990 until 1996. His career began at Memaco Limited, the copper marketing arm of the Zambian mining industry, from 1988 to 1999 and then at DTL Limited until 1990. Christopher holds a Bachelor of Arts degree from the University of Ulster in Northern Ireland

John Brynjolfsson ~ Armored Wolf
John Brynjolfsson is the Founder and CIO of Armored Wolf LLC. Brynjolfsson has over 20 years of investment experience and a background in risk management. Prior to founding Armored Wolf, he spent 19 years at PIMCO where he launched and grew PIMCO's Real Return platform to approximately $80 billion before his departure in early 2008. In this role, Mr. Brynjolfsson ran PIMCO's 2nd, 3rd, and 4th largest public funds, which included the world's largest commodities fund and two large inflation-linked bond funds. He is regarded as one of the world's foremost authorities on inflation linked investing, having written several books on the topic and worked with the US Treasury to design the TIPS market in 1996. Mr. Brynjolfsson has an M.S. in Management with a concentration in Finance and Managerial Economics from MIT, and an A.B. in Physics and Mathematics from Columbia University.

Angus Cameron ~ Komodo Capital Management
Angus Cameron is the Chief Investment Officer and Head of Macro Trading for Komodo Capital Management. He has more than 16 years of proprietary trading experience in financial markets. Prior to founding Komodo Capital, Cameron worked as a portfolio manager for Millennium Capital Management, Bank of America, West LB, Tudor Proprietary Trading and Bankers Trust. Cameron holds a Bachelor of International Business Relations from Griffith University, Queensland, Australia.

Adam Fisher ~ Commonwealth Opportunity Capital
Mr. Fisher is the Chief Investment Officer and co-founder of CommonWealth Opportunity Capital ("CWOC"). Fisher co-founded Orient Property Group ("OPG") in 2006 focusing on investments throughout the Asia Pacific region. OPG is backed by D.E. Shaw & Co. Fisher also founded Irongate, a property investment and development firm based in Los Angeles. Irongate and its predecessor entity were involved in property transactions in Florida, California, Hawaii, Mexico, and Canada. Fisher previously worked in New York for two private equity firms, NMS Capital and TD Capital, as well as a risk arbitrage firm affiliated with Reservoir Capital. Fisher is a founder and a principal shareholder of Signal Peak Mining LLC, a joint venture with First Energy (NYSE:FE) and the Boich Group. The Company is the owner of the largest underground long-wall coal mine in the United States. Fisher is also a founder and a principal shareholder of American Energy Group, a specialty chemicals manufacturer based in Milwaukee, Wisconsin. Mr. Fisher holds a JD/MBA from Columbia University and a BS from Washington University in St. Louis.

Hugh Hendry ~ Eclectica Asset Management
Hugh Hendry is the founder and CIO of Eclectica Asset Management. He has 19 years' industry experience and established Eclectica in 2005, along with a team of four former colleagues from Odey Asset Management LLP. They acquired the management contract for Hugh's global macro hedge fund, The Eclectica Fund, which was launched by Odey in October 2002. Hugh is a regular contributor to CNBC and Bloomberg as well as publishing research papers for practitioner and industry journals. Hugh Hendry graduated from University of Strathclyde with a 2:1 degree in Accounting & Economics and he also received a degree from the Institute of Investment Management & Research. Hugh wrote and starred in Channel 4's recent special "Don't Bank on the Bailout."

George Papamarkakis ~ North Asset Management
Papamarkakis is a co-founder, Managing Partner and Chief Investment Officer at North Asset Management ("North"). North is an alternative asset management company based in London and founded in 2002. Formerly Papamarkakis was one of the youngest-ever elected Managing Directors at Morgan Stanley within the Fixed Income Department. He was instrumental in developing Morgan Stanley's proprietary trading franchise and risk profile in derivatives, fixed income and foreign exchange in the European time zone. Prior to working at Morgan Stanley, he worked at Vereinsbank AG and Christiania Bank. George studied Political Science and International Relations at University of Athens, Law Department.

Dr. Lee R. Thomas III ~ Flintrock Global
Lee Thomas is the Chief Investment officer of Flintrock Global. Prior to starting Flintrock, Thomas was the Managing Director & the Chief Global Strategist at Pacific Investment Management Company (PIMCO) in Newport Beach, California. Thomas joined PIMCO in 1995 to manage & build the dedicated global bond division, PIMCO Global Advisors. Prior to PIMCO, he worked for Investcorp in London, New York and Bahrain from 1989 to 1995. At Investcorp, Thomas served as the Treasurer and was a member of the investment committee. From 1981 to 1989, Thomas worked in various economic, analyst, trading, structuring and sales roles at Chase, Citibank and Goldman Sachs. Lee received his PhD from Tulane University.