DrobnyGlobalMonitor

April 28, 2010

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Biases:

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

Current Exposure:

EQUITIES:	Short IBEX vs SPX (Mar 18);
BONDS:	Pay 2yr HKD swap (Feb 22);
FX:	Long USD vs SFr (Apr 13);
	Long USD vs JPY (Dec 1);

2010 Santa Monica Conference Review

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

An uneasy tension was evident at this year's SM Conference. We met in the midst of the Greece/Euro crisis, and at a time of mounting fears that the trouble is spreading. Naturally, this issue featured prominently throughout much of the day.

Yet, at the same time there was a generalized acceptance that a global growth spurt has commenced. And, growth can solve many problems. It's hard for a crisis to build and broaden when growth is accelerating. Crises build more easily in downturns.

For the US, the possibility of a bumper 500K US jobs number within the next few months came up in a post-conference conversation or two. Such a number would obviously be distorted by the census, but it would still add to a growing sense that a genuine improvement is underway. One panelist suggested selling US 5yr notes on the basis of this growth and employment spurt, and it's interesting that the audience was positioned the other way (see Questions 7 & 8, Section 11).

Growth acceleration can also change things in Europe. Perhaps not for the Greek economy itself, at least not in the first instance. Regardless of how the funding/default issue gets resolved, and whatever happens to the Euro, Greece looks set experience a deep and nasty recession/depression. They seem to have no alternative to austerity. As a result, one panelist suggested selling Greek bank shares.

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But, things could look rather different for Europe as a whole if, say, a big support package for Greece is passed before the summer recess, especially if a growth spurt becomes increasingly apparent in Germany and in much of Europe. That might suddenly make the Euro area seem a less dangerous place. That could reduce the attraction of Bunds, and make peripheral bond markets look a bit better (and a decent number in the audience seem positioned the other way, see Audience Favorite Fixed Income Trades, Section 12).

And, what about selling the Euro? Well, that certainly seemed a popular trade. Two panelists chose short Euro trades, and this was also a big favorite with the audience (Question 11, Section 11 and also Audience FX Favorite trades in Section 12). Some fretted the trade may be too popular (and there does appear to have been considerable position squaring, see Question 12, Section 11). So, the discussion turned to how the bailout/growth combo might provide a recipe for a rebound in the Euro.

Other panelist trades included an Argentina election trade, which raised the specter of 20%+ inflation in that country next year, a short Yen and Yen rates trade, and a commodity RV trade. Oh, and trouble's oldest friend – gold - also re-emerged as a panelist favorite trade choice, although this time in a rather different and fascinating format – buy physical gold. Rounding out the day was a neat structure to buy the US front end which was premised less on a directional macro view, and was designed more on exploiting anomalies that arise from US rates running at virtually zero.

I provide below a review of the 9 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) Michael Dooley of Cabezon Capital suggested selling 1yr Argentina CDS and buy USD/ARS 1yr fwd against it. There's inflation trouble brewing in Argentina, which will likely be exacerbated by the tendency of the ruling government to try to 'buy' the election coming up next year. That should eventually place upward pressure on USD/ARS and on ARS rates, but in the meantime a default ahead of the election seems highly unlikely. Hence the choice of selling the 1yr CDS.

Behind Mike's trade is a global environment of strong global growth, but one that is widely acknowledged to be fragile. As a result, the FED will want to reinforce the recovery and will likely wait 'too' long before tightening policy. And, something similar will likely happen in Argentina ahead of the election. Rates are around 11%,

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but inflation is rising rapidly and Mike predicted it will reach over 20% next year! That's a recipe for trouble, but trouble delayed a year.

2) Sri Wijegoonaratna of Galle Global Macro made a fascinating case for selling Greek banks. At first sight, the trade seemed late given how far Greek equities have already fallen. And, the Greek saga seems to have already gone a long way.

Yet, the case is pretty good. The Greek story may be widely known, but the economic collapse hasn't even started yet. Most forecasters are talking about a 2-3% drop in GDP this year, when a bust of 10%-plus seems much more likely. And, the severe austerity measures were only implemented in mid-March, so they are only now starting to filter out into the economy. And, that's just the first round of measures.

So, for the banks, it may not matter much whether a solution to funding problem is found or not. There's a nasty economic 'crunch' coming. And, although Greek bank stocks have come down considerably, that's against a likely big drop in loan volumes and bottom line compression. The wild card, though, is non-performing loans. They are running at 7% in Greece. That's low. In the Asian crisis of the late 1990's, non-performing loans reached 20%. Wiji argued that NPL's in Greece could easily double, which would effectively wipe out the existing capital base of the banks. Asset deflation in Greece….. makes a lot of sense.

3) Melissa Ko of Covepoint approached the Greek problem from a different angle and suggested selling the Euro against the Asian currencies, most specifically the TWD. The trade captures the notion that Greece and CNY, and by association most of non-Japan Asia, are in opposite ways caught up in inappropriate currency arrangements. In Greece it deflates the economy, requiring an overshoot of the Euro to the downside. In China and Asia, it creates an inappropriately easy monetary policy, which places upward pressure on the currencies [and presumably the equities].

This proved a very popular trade idea, though there was evidence in audience polls that positions had recently been scaled back. So, much of the discussion of the trade centered on what might change the trend. Hence the discussion of growth and bailouts into the summer period.

But, things got even trickier when the China side of the equation came into focus. Melissa argued that China seems set to change their currency policy but they probably now want something different from the past, something more unassailable. Like a Singapore basket type approach or wider bands.

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Ahh, that's when a clever member of the audience took the story one step further. He asked what happens to the Euro if Melissa is proved right and China moves to a basket currency regime rather than a USD-pegged one. True, it would likely enhance demand for Asian currencies, as their weight in the China reserve basket would likely increase. But, it could also likely produce an immediate bid for the Euro, as its weight in China reserves would also increase. It would be ironic, he lamented at the bar later, if Melissa is right on the story, but her trade doesn't perform because of this.

4) Jens Nordvig of Nomura presented a quick 'snap' trade and suggested selling Euro/Sterling. Another Euro short, this time against one of the biggest laggards on the crosses, sterling. The UK currency has been held down by politics, and was disproportionately hit by the financial crisis. The crisis has healed considerably and the UK economy seems to be picking up nicely. The upside to sterling is considerable, and the fact that it has lagged against the Euro leaves it well placed to withstand any rebound the Euro may experience. Especially since the Euro rebound would likely be associated with reduced default risk and thus an improved global growth profile.

5) Dan Tapiero of DTAP Capital made the case for buying physical gold. The case for gold is now well known. But, the new twist is the suggestion of buying physical gold, rather than paper gold. And, behind this is the idea of a possible/eventual short squeeze on physical gold. (Dan drew on the very thorough research by John Burbank and his team at Passport Capital, who recently produced a white paper on the physical gold; this will be reproduced as a DGA Guest Piece in the very near future).

The commodity boom has generated a fantastically large paper market in these assets. And, something unusual may be happening with gold, since almost all futures contracts are settled financially, with little or no connection with the physical asset. Dan questions whether gold ETF's hold the required amount of the physical asset. Do the auditors actually look at the physical bullion held or simply trust the financial statements of the companies and trusts that issue the ETF's? And, apparently no one has yet requested settlement with the physical. There are thus many unanswered questions raised about the whether there is sufficient physical gold backing the mushrooming paper interest in the asset.

And, now, supply of physical may be falling. This isn't so much about production, which has been declining for a while. More important is that central banks, whose stock of holdings dwarf production levels anyway, have recently become net buyers of the physical after some two-to-three decades as net sellers. The amount of gold on the street may thus be declining, even as investment demand for paper gold is rising. That

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sets the stage for a short squeeze on the physical. And, the intriguing possibility that the ETF's and other paper instruments may lag in value relative to the physical.

So, if you want to be long gold, the argument is to buy the physical. And, that is getting easier to execute and isn't costly, though does require a bit more attention to detail. Or, as an alternative, buy the physical and sell the paper to give you exposure to the low delta but potentially very powerful event of a short squeeze on the physical. This trade can provide a powerful hedge against a nasty credit event in the commodity/gold arena. By the way, one questioner mentioned that a similar problem with the physical arises in the silver market as well.

6) Anu Murgai of Suranya Capital argued for selling US 5yr bonds. Anu led off in the afternoon session, and her presentation helped unmask the tension in the macro environment. She claimed that the US economy is at an inflexion point. A burst of growth is taking place. And, because employment was cut drastically at the start of 2009, this growth burst should involve surprisingly strong employment growth.

That's the basis for the 500K payroll number idea. Such an outcome could well change perceptions on the overall fragility of the economic environment and perhaps about the risk of default generally. Growth is a powerful lubricant for debt problems. But, most importantly she argued, it could change the outlook for US rates.

Why, then, sell 5yr's?, she was asked. If she is right about the economy, it is the 2011 Eurodollar contracts that can get crushed in a short period? That's where the best juice lies for her story. Just as occurred in Canada and Australia, when the growth rebound suddenly enhanced expectations of near term tightening by the central bank. Anu's response was simply that she was agnostic on what the FED will actually do, so didn't want to take a view on the yield curve. Hence the 5yrs.

7) Kyle Bass of Hayman Capital suggested selling the Yen and paying 2yr and 3yr Japan swaps along with it. The savings ratio in Japan has dropped sharply in the past year or so. This means that, unlike in the past, the economy will suffer from a flow of funds deficit. That means that any recovery will likely involve both a lower Yen and higher rates; the convexity with the latter is where the real juice to the trade comes in.

The idea of selling the Yen was highly popular and pretty much consensus for the group. Several in the audience chose it as a favorite trade (Section 12 and also Questions 2 & 3 in Section 11). The controversy with this trade centered on the rates side. Why wouldn't the BoJ simply continue to intervene to depress yields as recovery unfolds? Sure, ultimately there could be a price to pay for this in the form of much

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higher rate volatility later if the BoJ repress upward pressure on rates. But, maybe that is a price they will be willing to pay to ensure an exit from deflation?

Moreover, when asked, Kyle seemed to admit that the first and important move in the process should be Yen weakness. It is only after the Yen has begun to decisively weaken that the BoJ might have a comfort level to reduce QE and let rates start to ease higher. [This also suggests buying the Nikkei; economic recovery, Yen weakness and stubbornly low rates sounds pretty good for NKY outperformance.]

8) Julian Barrowcliffe of Chichester Capital presented another 'snap' and quick trade, and pushed a commodity box trade: bull spread high sulfur fuel oil and bear spread in Brent crude, at a spread of -$1.00 per barrel, looking for a move back towards $4.00+ per barrel. The market is currently short of high sulfur oil and overweight in low sulfur Brent oil, which has created the anomaly. This results from a turnaround in the worldwide refinery system which shut down a large amount of upgrading units and created a temporary oversupply of fuel oil. Yet, the macro conditions exist for a return of the secular strength of fuel oil: OPEC is still holding heavy sour crude off the market and the upgrading units are about to come back on stream. That should result in a steeper curve for the high sulfur stuff and a flatter curve in the premium low sulfur oil.

The discussion of this trade surrounded the risks and appropriate hedges. The trade is essentially a low vol trade and would be badly hurt if the price of oil jumps up to over $100. In this sense, the box trade is equivalent to selling low delta oil calls but, as Julian noted, while earning a much much bigger premium.

9) Chris Leonard of Alphadyne Fund closed the day presenting a long the US front end trade. This trade was less about the view, and much more about exploiting the asymmetries associated with the zero bound on rates. When rates are near zero, they can really only go higher. So the market must build in higher rates and, after a big back up in rates, the roll down potential becomes very attractive. Against this, he cautioned, is the risk that when rates eventually move they could go up a long way and quickly.

Chris' trade presented a neat way to exploit the anomaly while limiting the downside risk from eventual quick and large rate hikes. He suggested buying 3mth ATM Forward 2yr receiver swaps, and selling 3mth ATM Spot 2yr receivers against them. This structure would produce roughly 3-1 bets and exploits the asymmetry inherent in a zero rate regime and also low rate vol. His approach has been to enter the structure each time 2yr rates backed up. And, he pointed out that this happened just ahead of the conference, so he was at it again.

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Chris admitted that he re-entered the trade even though he felt the US economy was now probably experiencing a strong recovery. However, high unemployment meant the FED would likely stay quiet until the unemployment rate had fallen substantially. So, even in the event of employment growth of, say, an average of 300K jobs growth per month, it still would take another two years for unemployment to have fallen to NAIRU type levels. So, assuming the FED start tightening with a 12 month lead time, that would still take us to Q1 2011. And, remember, that's based on an average 300K per month, a pretty aggressive assumption.

Oh, and that takes us back to that discussion of US employment at the afterparty. It was pointed out that, even if the next employment reports are huge, everyone should be prepared for a shockingly low one around August/September time as some of the census factor gets eliminated. Good point! And, a recipe for potential bond volatility. Just what Chris needs to get more opportunities to execute his trade, or maybe some variant of the trade that takes into account higher vol.

Andres Drobny

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10) Drobny Award Recipients

The following three Drobny Awards were presented at this conference:

1) <u>Best Trade at 2009 London Conference</u>: ***Mike Wissell and Ziad Hindo of Ontario Teachers***, who suggested selling long dated equity vol by selling Dec 2018 S&P variance swaps at 31%. This exploited a very steep vol curve at a time of generally declining equity vol.
2) <u>Best Trade at 2009 SM Conference:</u> ***Michael Dooley of Cabezon Capital***, who suggested buying Brazilian equities at near the worst point in the downturn.
3) <u>Best Guest Contribution to DGA Piece:</u> ***Anonymous(!)***, who was the SG who questioned Niall Ferguson's thesis comparing the US to Greece and taught us all something crucially important about fiat currencies and the sovereign debt problem (*'The Ferguson Thesis'*, **DGA Views,** Feb 25, 2010).

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

1) What is your estimate of Goldman Sach's share price in one year's time?

$500	0	0%
$250	22	28%
$150	43	54%
$50	15	18%
$0	0	0%
	Total Votes --80	

2) What is your current view regarding the Japanese Yen?

Very bullish	5	6%
Moderately bullish	2	3%
Neutral	13	15%
Moderately bearish	43	51%
Very bearish	21	25%
	Total Votes --84	

3) What is your current positioning in Japanese Yen?

Very long	3	4%
Moderately long	5	6%
Neutral	42	53%
Moderately short	22	27%
Very short	8	10%
	Total Votes --80	

4) What is your view regarding the yield on 10 year Japanese Government Bonds in 2 years' time?

1% or less	6	8%
1 to 1.5%	8	10%
Between 1.5% and 2.5%	39	50%
Between 2.5% and 3.5%	17	22%
Above 3.5%	8	10%
	Total Votes --78	

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5) What is your current positioning in 10yr Japanese Government Bonds?

Very long	1	1%
Moderately long	1	1%
Neutral	62	85%
Moderately short	6	8%
Very short	3	4%
	Total Votes --73	

6) By when will the Fed initiate the first rate hike?

By third quarter 2010	5	6%
By fourth quarter 2010	10	11%
By first half 2011	37	44%
By second half 2011	22	26%
After 2011	11	13%
	Total Votes --85	

7) What is your current view regarding US 5 year treasuries?

Very bullish	8	10%
Moderately bullish	28	34%
Neutral	20	24%
Moderately bearish	22	27%
Very bearish	4	5%
	Total Votes --82	

8) What is your current positioning in US 5 year treasuries?

Very long	3	4%
Moderately long	15	20%
Neutral	44	59%
Moderately short	11	14%
Very short	2	3%
	Total Votes --75	

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9) Where will Fed Funds rates be by the end of 2011?

Unchanged	10	13%
At 50bps or less	9	12%
Between 50bps and 1%	18	22%
Between 1% and 2%	25	31%
Above 2%	18	22%
	Total Votes --80	

10) Where will Fed Funds rates be by the end of 2011?

At 50bps or less	11	15%
Between 50bps and 1.5%	20	27%
Between 1.5% and 2.5%	23	32%
Between 2.5% and 3.5%	16	22%
Above 3.5%	3	4%
	Total Votes --73	

11) What is your current view regarding the Euro?

Very bearish	31	40%
Moderately bearish	36	48%
Neutral	6	7%
Moderately bullish	3	4%
Very bullish	1	1%
	Total Votes --84	

12) What is your current positioning in Euro?

Very short	11	15%
Moderately short	29	41%
Neutral	26	37%
Moderately long	5	7%
Very long	0	0%
	Total Votes --77	

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

Fixed Income Total: 29

Largest samples:

5 Bull flattener in US;
4 Long Bunds vs short European peripherals;
4 Long front ends (3xUS, 1 in Euro)
3 Short US BreakEven inflation
2 short US 10yrs

Most interesting/unusual: Long Argentina bonds; pay Hungary CDS;

FX: Total: 25

Largest samples:

9 Short Euro (4 TWI, 2 Euro/GBP, 4mth Euro/USD 1 touch x=1.15)
5 Short Yen (3x CAD/JPY, 2 TWI)
3 Long USD
2 Long MEX/CAD

Most interesting/unusual: long Asian Gamma

Equities: Total trades: 16 (including EMG equities)

Largest samples:

4 Short S&P
3 Long S&P
3 Short Banks (BKX, Euro banks, French Banks)
2 Short US
2 Long US (1 Long financials)

Most interesting/unusual: Very mixed equity views; 8 long, 8 short.

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Commodities Total: 12

Largest samples:

2 Long Crude Oil
0 Net Gold (2 long and 2 short, one an RV trade)

Most interesting/unusual: 10 longs, 1 short (gold), 1 RV (long oil vs short gold)

Other Favorite Trades: 4

Long VIX
Long CRB vs Euro
Long Oil vs Yen
Short peak electricity in California

PANEL BIOGRAPHIES ::: Santa Monica - 2010

Julian Barrowcliffe ~ Chichester Capital
Julian Barrowcliffe is Portfolio Manager of Chichester Capital. From 2004 to 2009, Barrowcliffe was a Managing Director of Proxima Alfa Investments and Senior Portfolio Manager of its Anglian Commodities Team. From 1999 to 2004, he was Global Head of Commodities Trading at Bank of America in New York. From 1996 to 1999, Barrowcliffe was part of Cinergy Capital and Trading, where he developed the recently deregulated utility's derivatives trading capability. Barrowcliffe was Head of Energy Trading at Merrill Lynch from 1993 to 1996. He was at Bankers Trust from 1987 to 1993 and Shell International from 1985 to 1987, and received his B.A. (hons) D.I.S. Business Administration & French from Loughborough University of Technology in the United Kingdom.

J. Kyle Bass ~ Hayman Advisors
J. Kyle Bass is the principal of Hayman Advisors, formed in December 2005. He is a Director of the ABS Credit Derivatives Users Association Inc. and a founding member of the Serengeti Asset Management Advisory Board. Prior to forming Hayman Advisors, Bass worked at Bear, Stearns & Co. Inc. for 6 years where, at age 28, he became one of the youngest Senior Managing Directors in the firm's history. From 2001 to 2005, Bass worked at Legg Mason, Inc. as a Managing Director. Bass graduated with a Bachelor of Business Administration in Finance and Real Estate Finance (honors) from Texas Christian University in May 1992.

Dr. Mike Dooley ~ Cabezon Capital
Mike Dooley is Partner and Research Director of Cabezon Capital, and is the leading author and originator of the Bretton Woods II concept. Prior to Cabezon, he served a number of roles at Deutsche Bank, including consultant, Chief Economist for Latin America, and more recently Senior Advisor for Global Markets (with emphasis on emerging markets). Since 1992, Dooley has been a professor at the University of California Santa Cruz. He is a research associate at

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the National Bureau of Economic Research and is a managing editor of the *International Journal of Finance and Economics*. Dooley's consulting relationships include the International Monetary Fund, World Bank, and Federal Reserve Board. Dooley received a Ph.D in Economics from Penn State and a M.A. in Economics from University of Delaware.

Melissa Ko ~ Covepoint Capital

Melissa Ko is CEO and Senior Portfolio Manager of the Covepoint Emerging Markets Macro Fund. Previously, she served as a Senior Managing Director at Bear Stearns & Co., where she founded the Bear Stearns Emerging Markets Macro Fund. Ko was one of the architects of the Non-Deliverable Forward (NDF) markets. Before joining Bear Stearns in October 2002, she was a Partner at Blue Border Partners, an Emerging Markets Hedge Fund. She has been a Director with Deutsche Bank in charge of Emerging Markets Proprietary Trading and was Head of the Latin American Currency Desk at Bankers Trust. Ko also held various trading positions at Citibank and ABN-Amro. She received a B.S. in Chemical Engineering from the Massachusetts Institute of Technology in 1990 and an M.B.A. from the Wharton School in 1994.

Christopher Leonard ~ Alphadyne Asset Management

Chris Leonard is a Partner at Alphadyne Asset Management and lead Portfolio Manager responsible for the Liquid Rates investment strategy. Prior to Alphadyne, Leonard spent ten years at JP Morgan, where he ultimately served as Managing Director and Head of the New York Interest Rate Swaps and Options Trading business. He currently serves on the board of Harlem RBI. Leonard graduated magna cum laude from Princeton University with a B.S. in Mechanical Engineering.

Anu Murgai ~ Suranya Capital

Anu Murgai is the General Partner and Portfolio Manager of Suranya Capital. Prior to forming Suranya Capital, Murgai was a Managing Director at Shumway Capital Partners, where she managed the global macro portfolio. Formerly, Murgai was an analyst at Ulysses Partners, a proprietary trader at JP Morgan, and a member of the Tiger Management macro team. Murgai holds a Bachelors Degree from Swarthmore College and earned an M.B.A. from the University of Chicago.

Jens Nordvig ~ Nomura Int'l

Jens Nordvig joined Nomura Securities in October 2009 as a Managing Director and Head of G10 Currency Strategy. Nordvig joined Nomura from Bridgewater Associates, where he was a senior currency strategist. He spent 8 years with Goldman Sachs in various senior research positions in both London and New York, most recently serving as a Managing Director and Co-Head of Global Currency Strategy. Prior to joining Goldman Sachs, Nordvig was an emerging market economist with IDEAglobal in London. He has taught several courses in macroeconomics and econometrics, and authored a book on mathematics and economics (2001). He received bachelor's and master's degrees in economics from University of Aarhus in Denmark, where he also conducted postgraduate research to formulate new models for financial crises.

Dan Tapiero ~ DTAP Capital

Dan Tapiero manages DTAP Capital, a global macro fund. He has a 14-year track record investing and trading. During his career, he has worked with such notable investors as Steve Cohen (SAC Capital), Stan Druckenmiller (Duquesne Capital), and Michael Steinhardt (Steinhardt Capital). He is on the membership committee of the Economic Club of New York and is a member of Business Executives for National Security (BENS). Tapiero is a former member of the grain commodity exchanges KCBT, MGEX and WCE. Dan co-founded AGCOA, the first and largest US farmland REIT, with Duquesne and Goldman Sachs. He is also a co-founder of Gold Bullion International. He graduated Phi Beta Kappa with a BA (1990) and an MA in History (1991) from Brown University.

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S.P. Wije Wijegoonaratna ("Wije") ~ Galle Global Macro (GGM)
Wije has 15 years of experience as a global macro investor. Prior to starting GGM in 2010, Wije was a Partner at Fortress Investment Group LLC, where he had been a member of the Executive Committee since January 2005. From 1997 to 2004, Wije was a partner and co-CIO/CEO for Banyan Fund Management, the test case for the "Tiger Cub" model. From 1994 to 1997 he was the portfolio manager of ASEAN Investment, a global macro fund started by Hari Hariharan at NWI Management. Wije began his career in portfolio management at Citigroup, where he worked in various capacities from 1987 to 1994. Wije holds a Bachelor of Science in Computer Science from Bucknell University (1987).

Andres Drobny ~ Drobny Global Advisors
Andres Drobny is the founder of Drobny Global Advisors, a financial markets research boutique based in Manhattan Beach, California that advises a select group of hedge funds, proprietary traders, and global money managers on world markets. Before starting Drobny Global Advisors, he served as Strategist & Proprietary Trader at Credit Suisse First Boston in London and NY, and was on the Global Foreign Exchange Management Committee. Drobny also served as Chief Economist & Head of Research for Bankers Trust Company, London. Prior to entering the financial markets, Drobny was an academic economist at the Universities of Cambridge & London and holds a PhD in Economics from King's College, Cambridge.

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