DrobnyGlobalMonitor

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Biases:

EQUITIES:	Bearish; Bearish financials; Bullish Volatility
BONDS:	Bullish; Especially US long dated bonds;
FX:	Bullish Volatility; Bearish USD;
EMG:	Bearish Argentina; Bullish MEX interest rates/***Bullish USD/MXP**.

Current Exposure:

EQUITIES:	Long Dow Puts, again (May 23);
	Short BKX Index (Aug 8);
BONDS:	Long US T-bond Future (July 23);
	Long Sept EuroSFr/short Sept Euribor (July 18);
FX:	***Formerly Short USD/SEK**;
	***Long USD/MXP (Aug 29);**
	***Formerly Short USD/CAD;**
	Long Euro/SFr (July 25);
	Short USD/NOK (Dec 5);

The Great Experiment: Phase 2

***Please note latest changes to biases**

The great experiment continues into the fall trading season. The sharp and seemingly synchronized global downturn has been matched by an equally sharp policy response.

The mistakes of Japan 1990-91 and the US 1929-31 have not been repeated. The question is whether policy easing can succeed in preventing a nasty bout of equity market-led deflation.

And, we now seem to be entering stage two of the process. During stage 1, pervasive global economic weakness, and equity market fragility, was countered by aggressive action in the US (and talk of action in Japan).

The FED front-loaded rate cuts and the new US Administration cut taxes. Equity markets seemed to be collapsing, but bounced sharply in April and May as the extent of the policy easing became clear.

Several things have now changed. First, the economic signals are getting a bit confusing. The long awaited bounce in manufacturing, at least in the US and perhaps in Japan (!), might well be taking place.

But, in the US at least, the bounce looks to be facing a services sector/consumer headwind. Commercial property has softened considerably, and residential property looks increasingly exposed.

If all this is correct, then tomorrow's employment report could well give a very different message than that provided by the NAPM. It's funny how the US employment figures have shown only very modest drops so far in this downturn. That should change soon if the downturn has genuinely infected services.

The second major change concerns policy. The model now seems for less action by the FED, and more by others around the world.

The FED have already decelerated in their easing programme. Meanwhile, others seem to be cutting rates more readily.

The RBA, for example, seemed to justify their recent rate cut more on international considerations than due to domestic circumstances. The same internationalist game was played by the ECB, the Canadians, and I believe the British.

So, it seems that the period of falling relative US interest rates may now be behind us. Short rate spreads moved a long, long way over the past 9-12 months, and now seem to have stabilized.

All this suggests the US yield curve should flatten ***relative*** to curves elsewhere. The US curve is already steeper than virtually everyone else, apart from Japan.

And, as the risk of aggressive unilateral FED easing has diminished, others seem to be getting more aggressive now. For example, the Aussies have been cutting rates despite signs of an improved domestic economic outlook.

In contrast, the US easing seems to have, at best, matched a deteriorating economic performance. And, the UK curve, despite having steepened/normalized considerably over the past 18 months, remains exceptionally flat-to-inverted considering the global environment.

The trade that comes from this is to buy the USD 30yrs forward, and sell it back spot or, say, 2yrs forward, against most other currencies. For interest rate markets, this means that, if you are a deflationist looking to buy long bonds, look to the US. If you think short rates will come crashing down, then look ***outside*** of the US for the trade.

And, if you are an economic optimist and a seller of bonds, look to sell the Australian and UK long ends, not the US. Or, in the US, sell the front end.

With regards currencies, the conclusions seem, at first sight, rather surprising. It suggests selling the USD spot against the long USD 30yrs fwd position.

Despite a potential narrowing of spreads in favor of the USD? And a relative flattening of the US yield curve?

That sounds odd! Typically, if others are easing instead of the FED, this would be a recipe for USD strength.

But, this has been a rather atypical cycle; history has been a rather poor guide this time around. The USD strengthened as US rates fell and US economic performance deteriorated on an absolute and relative basis. Maybe, for some reason, the reverse will occur in stage 2.

Moreover, the real bearish case for the USD is based on the repercussions of equity market weakness. The more they fall, the greater the leverage being taken out of the system.

We saw this in Japan during parts of the 1990's. The equity market crash combined with debt repayment to produce a slowing of broad money growth. This was despite aggressive liquidity provision by the central bank.

This de-leveraging can provoke a drop in capital flows. If that's the case, then a drying up of capital flows disproportionately affects the currencies of debtor countries.

And who's the biggest debtor? It ain't Argentina!

Two more points. First, if genuine USD weakness emerges, then Euro/Yen and other Yen crosses could well bear the main burden of adjustment.

The BoJ have the greatest armory, and motive, to fight USD weakness. And, the way that one has been bouncing around recently suggests something pretty big may well be about to happen there. Euro/yen implieds sure seem low on a relative basis.

And, finally, there's the Mexican Peso, which looks like it's starting a pretty big move [funny, there's a ***long*** USD position!]. Did you see the tariffs on steel imports they have just introduced?

Their economy seems to be cracking in earnest and policy easing is necessary. Some of that, if not a lot of it, should occur with the currency. As a wise old sage reminded me once, the history of great convergence trades is that they are punctuated by big hiccups along the way.

Mexico may well be on a powerful convergence path with the US, but this certainly does not seem the time to buy into that!

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