DrobnyGlobalMonitor

November 19, 2004

206 44th Street Manhattan Beach, CA 90266 *andres@drobny.com* *(310) 397-4360*

Biases:

EQUITIES: Bearish; Bearish financials; Bullish TPX vs SPX.
BONDS: Neutral, Bearish US Corporate Bonds & 2yr JGB vs
Bullish 10yr Bunds;
Bearish US Credit spreads;
FX: Bearish USD; Bullish SFr; Bullish Volatility;
EMG:
CMDTY:

Current Exposure:

EQUITIES: Long NKY vs DOW (Oct 28);
BONDS: Long Bunds (Sept 8):
Short 2yr JGB (June 2);
FX: Short USD/THB (Oct 8);
Short USD/SFr (Sept 30);
Short Euro/SFr (Aug 26);
Long 6mth Call on SFr vs Yen (Aug 8);
EMG:
CMDTY:

Barcelona 2004 Conference Review

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

The USD was the elephant in the room at this conference. Short the USD was the favorite trade in the audience poll taken at the start of the conference. By far.

Yet, when a hand poll of the group was taken during the event, maybe 2/3's claimed to be short. And, 1/3 were actually countertrading and were ***long*** the USD. So, on average, it seems the group was bearish but without running a big net position. Very different from late 2003/early 2004.

Similarly, the trades presented by the panel were various and diverse, and the USD certainly cropped up. But, it wasn't anyone's favorite trade!

www.drobny.com
Copyright © 2004 DrobnyGlobalTrading, LLC.
No reproduction, transmission or distribution permitted without consent of the copyright holder.

Perhaps this reflects a fear of being overly in line with consensus. Or, maybe the USD has moved so far recently that a big unwind seems a threat.

Both are reasons to run a short USD position, but not a maximum short one. Yet, this in turn suggests the USD has a lot of downside potential right here. And, that high USD volatility into year end looks likely (and is certainly not in the price)!

Instead, the favorite trades presented by the panel concentrated on spreads, with Russia and non-Japan Asian currencies popping up more than once. There was one very directional trade - short US bonds - that stimulated considerable debate and controversy.

I provide below a review of the 7 trades presented and the subsequent discussions (bios of the speakers are provided at the end of the piece). The occasional comments in brackets [………..] represent my own additional post-conference comments.

Suggestions, amendments, complaints, etc would all be happily received.

1) Jim Leitner of Falcon Family LP suggested ***buying the Swedish Krona against the Euro.*** Euro/Stockie has been in a range for some 2 ½ years now, which has prompted a lot of selling of vol on the cross. With optionality cheap, he bought 1yr 8.70 SEK calls/Euro puts for ½%. He believes this cross rate could well move to the low 8's, which gives a 5-10% potential gain against the ½% cost of the option.

The trade is motivated by thinking about 'good' countries and 'bad' countries. The US is notorious for its dual C/A and budget deficits. So, where are the dual surplus 'good' countries? One of those is Canada. And, the recent amazing rally in the Canadian dollar helped motivate the trade. The CAD took a surprisingly long time to rally. But, when it did, it went hard and fast.

And, the same could occur with the stockie. It has a 7% C/A surplus and a ½% Budget surplus. PPP estimates against the Euro run at around 8.0. And, with the economy growing pretty strongly, the central bank should be comfortable to accept currency appreciation.

So, why hasn't Euro/Stockie moved a lot lower already? Jim's answer was neat: there have been substantial domestic pension fund outflows due, in part, to inheritance tax avoidance reasons. Thus, as with Canada, there probably is a substantial domestic short of the currency already. And, intriguingly, Jim noted that there is a

Copyright © 2004 DrobnyGlobalTrading, LLC.
No reproduction, transmission or distribution permitted without consent of the copyright holder.

bill before the Swedish parliament to reduce the inheritance tax. If passed, it could substantially reduce the size of the outflow.

2) Tim Rustow of DTAP Capital suggested two trades to exploit further potential upside to the price of oil. One trade was to ***buy oil service holdrs trust (OIH)***, an ETF index of oil service companies. The other was to ***buy the Russian Ruble***.

The oil story is based on the now familiar problem of excess demand. Demand growth is high, yet supply is struggling to keep up. Oil is produced in unstable regions and, more ominously, the peak in global oil supplies is very near. And, with an antiquated infrastructure, there are lots of potential bottlenecks ahead.

Is this in the price? After all, the oil price has rallied a long way since the last Drobny Conference, where long oil was also recommended. Tim suggests no, for three reasons. First, although up, Wall Street consensus forecasts for the oil price is still at around $35. That's well below spot and forward prices. Second, net speculative positions suggest the speculative market is actually net ***short*** oil! And, third, the share of oil companies as a percent of total S&P capitalization has become very low, which seems rather inconsistent with an overdone market.

So, his first trade is to buy OIH, whose price seems to reflect an assumption for the oil price which is very far below the forwards. Moreover, these oil service guys have fixed costs, so you get very good leveraged exposure to further increases in oil prices.

The second trade is to buy the Russian Ruble. Here's another dual surplus country with a very cheap currency where FX reserves are exploding. This is the result of a Government policy limiting currency appreciation, achieved by keeping real interest rates negative. As a result, inflation has been overshooting Government targets. So, monetary policy simply must tighten, increasing upward pressure on the currency. A revaluation seems inevitable, and it could be substantial given the cheapness of the currency. This is especially true if the price of oil stays at current levels, or goes higher.

3) Renee Haugerud of Galtere, Ltd suggested a ***10's-30's steepener in US Treasuries.*** This is a positive carry trade where, admittedly, the starting point is near the highs. Yet, the potential for a break out to a new higher spread is substantial in a world she characterizes as the reverse of the 1970's stagflation.

Copyright © 2004 DrobnyGlobalTrading, LLC.
No reproduction, transmission or distribution permitted without consent of the copyright holder.

The concept of inverse stagflation suggests an environment of decent growth combined with very low inflation. Growth is enough to push up commodity prices (especially in a bear USD environment), but not enough to generate generalized inflation nor solve the US budget deficit problem. This leads her to a portfolio that is short equities (growth is good but pricing power poor), long commodities, and a US yield curve where the mid-section outperforms the wings [presumably she means in yield terms].

Growth places upward pressure on short rates, yet low inflation holds down yields at the mid part of the curve. And, budgetary problems can keep yields high at the 30yr sector, especially with the risk of a resumption of issuance of very long dated Treasury paper. She prefers the 10's-30's steepener to, say, a 2's-10's flattener for two reasons: (1) the latter is positive carry; (2) the latter is a popular trade while the former is not.

The trade stimulated considerable debate. Several bond experts complained that this is a bullish bond type trade. The 10's-30's curve tends to steepen when short rates are falling rather than rising. And, the trade goes against traditional correlations, it was argued. Moreover, the pension fund problem means they will increasingly need to buy long dated paper to better match their assets with liabilities.

All the more reason, she argued, why 30yr issuance should resume in the US. It will give the Treasury an opportunity to give the pension funds what they need, while helping solve what may prove an increasingly tricky funding problem. [And, regarding traditional correlations, that's what happens in a new environment…………the usual correlations break down!]

4) Lee Thomas, of Alpha Vision Capital, suggested ***selling US Treasuries.*** There's been a powerful rally and the levels for the short are good.

His argument was that the US economy is now in an expansion phase, not a recovery phase. During a recovery, growth is typically above potential. Interest rates rise, but are typically below 'equilibrium'.

In an expansion, the trick is to keep growth at potential. And, that requires rates to be around 'equilibrium', which he defined for longer term bond yields as roughly at a 3% real rate. With the FED running an informal inflation target of something between 2 ½-3%, that would suggest a 10yr bond yield at around 5 ½-6%. That's a pretty long way from here.

Another interesting debate ensued. It seems that interest rates is where the biggest differences in the group exist. And, interestingly, virtually no one in the audience

Copyright © 2004 DrobnyGlobalTrading, LLC.
No reproduction, transmission or distribution permitted without consent of the copyright holder.

chose a directional bond trade as their favorite. But, in a hand vote of the audience, the majority were actually short bonds! The opposite of the USD situation: few liked a bond trade as their favorite, but many were running a short bond position. Short bonds may be more of a consensus trade than short USD!!

Yet, there was a vehement argument on the other side. Several members worried that growth next year in the US will be weak. Short rates were going up, oil prices should dampen growth and fiscal policy was unlikely to become more stimulative. So, where exactly would the growth impetus come from? And, when the obvious answer arose……..exports due to the falling USD……..it turned out that many were particularly pessimistic about growth ***outside*** the US. Quite a conundrum, which remained unresolved.

One solution that was suggested was that, instead of selling Treasuries, why not just buy equities. If growth is sustained, yet rates are low, then equities can surprise on the upside. And, unlike the Treasury short, long equities can be a positive carry trade.

5) Dan Morehead of Pantera Capital suggested an eclectic mix of trades: ***(1) buy Malaysian equities; (2) buy non-Japan Asian currencies against the Euro; and (3) buy Polish real rate bonds.*** A driving force in the first two trades is that non-Japan Asian currencies are cheap and have so far underperformed in the USD downmove. The third trade is a little anomaly he discovered.

First Malaysian equities. The macro environment seems very supportive. The currency is pegged to the USD. It is therefore very cheap and getting cheaper. The peg has also kept interest rates very low and the C/A surplus very high.

But, there are other advantages to these puppies. They are trading at a very low P/E and foreigners have been exiting this market, rather than entering it for several years now. Moreover, Malaysia may be relatively insulated from other potential exogenous shocks. It's a net oil exporter. And, unlike other Asian countries, Malaysian exports of industrial goods to China account for only a small proportion of overall exports. Malaysia is thus less exposed than most other Asian countries to a potential hard landing in China. Finally, trading the currency is restricted. So, buying Malaysian equities gives you FX exposure that is otherwise not available.

Dan's second trade, buying Asian currencies (excluding Japan) against the Euro proved more controversial. The Asian currency side was fine…….these currencies have underperformed against the USD and are therefore very cheap on real TWI basis. But, why use the Euro as the liability currency? Isn't he going against

Copyright © 2004 DrobnyGlobalTrading, LLC.
No reproduction, transmission or distribution permitted without consent of the copyright holder.

the trend, trying to pick a top? His basic argument, it seemed, is that the market is overly bullish the Euro given that the currency looks expensive and with Euroland growth so weak. There was an interesting discussion on whether growth differentials are the main determinant of currency moves.

Dan's final trade, buying polish real rate bonds, seemed quite a catch. He dubbed this trade the 'Jim Leitner Memorial Trade Idea'! These are brand new bonds and are being auctioned at a real rate of almost 4%, almost 200bps over equivalent bonds in Euroland. There is potential for a sharp narrowing of spreads if/when these bonds gain acceptance. And, in the meantime, you earn really good carry. The problem, of course, is that this is a new and pretty thin market. So, although this trade should provide excellent returns, it's certainly not going to make anyone's career! Nonetheless, many participants wanted a piece of this one.

6) Mike deSa, of Vinya Capital suggested a ***Russia/Brazil divergence trade***. The specific trade structure he recommends has 4 legs: (1) sell 10yr Russia Sovereign CDS (credit default swap) at 255 spread (to the US); (2) buy 2yr Russia Sovereign CDS at 111 spread; (3) Buy 10yr Brazil Sovereign CDS at 470 spread; and (4) sell USD/BRL 3mth fwd at 2.94 (spot at 2.83).

This is a bullish Russia/bearish Brazil trade, with the core being the 10yr spread which is currently at long term lows. Trades (2) and (4) are essentially hedges on the two legs, which also turn the structure from negative to a positive carry.

Mike's idea is that Brazil has peaked, both economically and politically. Yet, the market is very bullish Brazil, with credit priced very aggressively now.

The problems in Brazil center on the limitations to growth. Capacity utilization is now very high so there is little room for faster growth. As a result, inflation has been building. That, in turn, is placing upward pressure on interest rates. The prices of some Brazilian commodity exports have dropped hard (soybeans), pulling down export earnings. And, at the same time, the opposition forces have been strengthening, limiting the Government's ability to get their legislative programme through.

Against buying Brazilian CDS (the Brazil 'short'), Mike likes selling the equivalent Russian CDS at a very attractive looking spread. He argued that there is very little risk of contagion to Russia should a problem in Brazil were to emerge.

One question that emerged was that, at a 255 spread to the US, why play the credit side of Russia at all? Is there any further downside to the CDS spread against the US?

Copyright © 2004 DrobnyGlobalTrading, LLC.
No reproduction, transmission or distribution permitted without consent of the copyright holder.

Mike appealed to China, where the equivalent spread is running at around 90bps. Moreover, there is lots of potential for Russia to be revalued as a credit, especially with a potential credit upgrade on the horizon.

7) Finally, my own trade was to ***buy non-Japan Asian currencies against the Yen, 2yrs forward outright.*** The main currencies on the list were the TWD and the THB. But, a cute little [and, it seemed, unpopular] HKD/Yen trade was also mentioned.

The underlying idea is that the Asian currencies are exceptionally cheap on a TWI basis. This is in part because some are tied to the USD. It is also because they never really recovered much after the Asian crisis in 1997-98. And, also because, since 2001, the authorities in all of Asia have resisted USD weakness.

But, now things seem to be changing. Rate hikes in several Asian countries suggests that inflation, rather than deflation, is becoming an increasing concern. That makes these guys more willing to tolerate a revaluation of their currencies.

All that is pretty well known. But, less widely recognized is a growing divergence in Asian monetary policy. Rates are going up in several of the countries.

But, not in Japan. Monetary policy there remains geared towards generating more inflation, unlike the others. This suggests that, as the USD comes down, the BoJ is likely to continue to resist a drop in USD/Yen below 100.

Unless, that is, the other Asians revalue considerably. That would allow the Yen TWI to fall, or remain stable, even if USD/Yen moves lower.

Moreover, although the Asian currencies look cheap against the USD, several are even cheaper against the Yen. THB/Yen or TWD/Yen are trading near historic lows, just at a time where this divergence in monetary policy is emerging. And, with forwards pricing in further Yen gains against these very cheap currencies. That creates conditions for a nice Asian cross carry trade.

The HKD/Yen trade proved more controversial. Yes, it is essentially a long USD position. Funny for a USD bear to recommend this one! But, the idea is to put maybe 5-10% of the Asia/Yen trade into this cross. It covers you in case of a year-end USD bounce or if the BoJ resist a break of USD/Yen at 100.

More importantly, why would anyone want to buy USD/Yen when you can buy HKD/Yen? That protects you if a generalized Asian revaluation emerges, at a cost

Copyright © 2004 DrobnyGlobalTrading, LLC.
No reproduction, transmission or distribution permitted without consent of the copyright holder.

of maybe an extra ½% (move in USD/HKD back to 7.80 from 7.77 currently). In other words, USD/HKD is trading near the top of its recent range, and so offers a cheap way to play for an Asian reval. It is lagging the move.

Always remember that this review is my own interpretation of the trades and subsequent discussion. I apologize if I did not do justice to any or all of the ideas and trades presented.

And, please send me your own comments on the proceedings. I would be happy to circulate them in a future piece or as part of our ***Guest Piece*** programme. And, of course, please get in touch with Steve or me if you are interested in presenting a trade idea at a future conference.

Finally, we presented a few more ***Drobny Awards*** at the conference. The recipients were:

Best Trade Presented at the last DrobnyConference:

> ***Mark Shulze, Black River Asset Management – long Sugar.*** Mark argued that sugar was lagging the generalized move in commodity prices and had become very cheap relative to close substitutes. He noted, for example, that the price of corn, a sweetening substitute, was at a 5yr high while sugar was near a 20yr low! By mid October, the price of sugar had jumped some 40% since the conference.

Inspiration Award:

> ***Marc Hotimsky, New Finance Capital Partners, Ltd.*** Marc built the FX business at CSFB from 1992, and was my boss. The business was centered around a 'trade with us philosophy', in an attempt to create synergies between an aggressive prop trading business and a client driven execution business. We would share our ideas with clients and, if we were profitable, they would come back to us for trade ideas and execute through our desks. This model proved very successful and, with hindsight, seems the inspiration for the DrobnyGlobal model of transparency where macro hedge funds share their ideas and thought processes with each other. Its amazing how funds can share ideas and thought

Copyright © 2004 DrobnyGlobalTrading, LLC.
No reproduction, transmission or distribution permitted without consent of the copyright holder.

processes, yet express the trades in very different ways and formulations. In a very real sense, Marc taught us all that valuable, and profitable, lesson.

Best Contribution from the Audience at a DrobnyConference:

Niall Ferguson, Harvard University. Niall was our guest speaker the day before the conference and proved immensely popular and provocative. The praises are still coming loud and strong. But, he went further, attended the full conference and actually spoke up and joined the debates and discussions. And, although he is a non-market guy, he held his ground well despite being surrounded by aggressive and opinionated hedge fund types.

OK. That's it. See you all at the next conference – Santa Monica 2005 – for another round of disciplined debate and sharing of trade ideas.

PANEL BIOGRAPHIES

Michael deSa ~ Vinya Capital

Michael deSa is the Co-Founder and CIO of Vinya Capital, a Connecticut based global macro hedge fund. Michael founded Vinya after leaving Merrill Lynch where he was the Global Co-Head of Rates & Foreign Exchange from 2001-2004. At Deutsche Bank between 1994 and 2001, he served as a Member of the Executive Board, COO of Deutsche Asset Management, Head of Asian FI, Equities and EM and Head of Global Foreign Exchange. Michael began his career at Citibank as an Emerging Markets Trader from 1977-1988 and served as Head of North American Foreign Exchange and Derivatives from 1988-1994. Michael holds a BCom from the University of Bombay and a PMD from Harvard Business School.

Renee Haugerud ~ Galtere

Ms. Haugerud is the CIO/Managing Principal of Galtére Ltd, a global macro and commodities hedge fund. Prior to founding Galtére, Ms. Haugerud served as the Financial Trading Manager for Hunter Douglas N.A. from 1997 to 1998. She also spent two years in Hong Kong with Natwest as the Head of Proprietary Trading. From 1980 to 1994 she held various top management and trading positions for Cargill, Inc. Ms. Haugerud received her B.S. degree with Honors in Forest Resource Management from the University of Montana in 1980.

James Leitner ~ Falcon

Jim Leitner is the investment manager of Falcon Family, L.P. Falcon Family, L.P. has averaged 37% annual returns since inception in 1997. Before founding Falcon, Jim was head of Bankers Trust European Trading and established their Currency Anomaly Fund, which returned 40% per annum under his management. Jim earned a B.A. degree in Economics with a minor in Russian Studies at Yale University. He also has a MA in International Affairs from Columbia and a JD from Fordham Law School.

Copyright © 2004 DrobnyGlobalTrading, LLC.
No reproduction, transmission or distribution permitted without consent of the copyright holder.

Dan Morehead ~ Pantera Capital

Dan Morehead is the founding partner and portfolio manager for Pantera Capital, a global macro hedge fund based in San Francisco. Prior to founding Pantera, Mr. Morehead was co-founder and CEO of Atriax, a foreign exchange trading platform. Previously, Mr. Morehead spent four years at Tiger Management, where he was Head of Macro Trading and CFO. Before joining Tiger, Mr. Morehead held various trading positions at Deutsche Bank, Bankers Trust and Goldman, Sachs. He graduated magna cum laude from Princeton University with a B.S. in Civil Engineering.

Tim Rustow ~ DTAP Capital

Tim Rustow is a portfolio manager and strategist at DTAP Capital, a Connecticut based global macro hedge fund. Prior to DTAP, Tim served in the similar capacity at SAC Capital and Falcon Family where he worked under Jim Leitner. Tim also worked as a currency strategist at Bankers Trust. Before entering financial markets, Tim was a journalist with ABC News, a campaign advisor for Rudy Giuliani and a foreign policy aide in the US Congress. Tim has a JD from St. John's University School of Law and Bachelors in Political Science from UC Boulder.

Dr. Lee R. Thomas III ~ Alpha Vision Capital

Lee Thomas is the Chief Investment officer of Alpha Vision Capital & the Vision Fund Group, a suite of global macro absolute return products offered by Allianz Global Investors. Prior to starting Vision, Lee was the Managing Director & the Chief Global Strategist at Pacific Investment Management Company (PIMCO) in Newport Beach, California. Lee joined PIMCO in 1995 to manage & build the dedicated global bond division, PIMCO Global Advisors. Prior to PIMCO, Lee worked for Investcorp in London, New York and Bahrain from 1989 to 1995. At Investcorp, Lee served as the Treasurer and was a member of the investment committee. From 1981 to 1989, Lee worked in various economic, analyst, trading, structuring and sales roles at Chase, Citibank and Goldman Sachs. Lee received his PhD from Tulane University.

Andres Drobny

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 & global money managers on world markets. Before starting Drobny Global Advisors, Drobny served as Strategist & Proprietary Trader at Credit Suisse First Boston in London & 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.

Copyright © 2004 DrobnyGlobalTrading, LLC.
No reproduction, transmission or distribution permitted without consent of the copyright holder.

This document is provided solely for informational purposes. It is not intended as an offer to buy or sell any instrument or security nor as advice or recommendation to participate in any particular trading or investment strategy. The content is based on or derived from information generally available to the public from sources believed to be reliable. No representation or warranty, express or implied, is made as to its accuracy or completeness. Past performance should not be taken as an indication or guarantee of future performance and no representation or warranty, express or implied, is made regarding future performance. Opinions expressed in this document may be changed without notice. Previous and future documents may be inconsistent with, and reach different conclusions from, what is presented in this document reflecting changes in assumption, underlying view or analytical method. This document may not be reproduced or redistributed to any other person, in whole or in part, without prior written consent from the author.

Copyright © 2004 DrobnyGlobalTrading, LLC.
No reproduction, transmission or distribution permitted without consent of the copyright holder.