

## The 3M Report. Monthly Market Memo: October 2008



<http://research.mfglobal.com>

### **DEBT MARKETS:**

U.S. 10 year futures are expected to range sideways with a slight up side bias on the back of weak economic conditions. TYZ8 should trade between 114-00 and 118-00. The treasury market is distorted by a concoction of fickle safe haven flows, and underlying economic weakness and falling inflationary pressures which are bullish. Poor valuation may make a strong price rally difficult. Treasuries are expensive relative to credit and equities. . Additionally, the passing of the TARP plan may lead to risk taking and weigh on fixed income prices. The major opportunities in the credit market rest in playing for aggressive monetary ease by the BOE and ECB, and trading for a prolonged period of low short term interest rates. Credit stress is expected to ease post monetary ease in Europe and government measures to support the banking system. The markets will then focus on weak economic conditions. The global economy is faltering with the global manufacturing PMI at 44.2 in September. The PMI is plunging toward the levels seen during the recession of the early 2000's. Consumer spending is restrained in the U.S. and Europe and housing shows little sign of recovery. Unemployment rates are up sharply in Ireland, Spain, and the U.S. indicating slack in the global labor market. Likewise, the emerging world is slowing with construction activity falling and hiring easing in Russia, slowing economic growth in Brazil, and loss of economic momentum in Asia. In Japan, the Q3 Manufacturing Tankan contracted to its weakest level since 2002, while the Chinese PMI was below 50 for a second month in September. Aggressive rate cuts by the BOE and ECB should allow September 2009 short sterling and Euribor contracts to rally sharply into next year. The BOE is likely to cut rates October 8<sup>th</sup> and Trichet's dovish tenor opened the door to ECB eases. There might be a coordinated move to lower rates if the TARP plan fails to stabilize the system. The Fed will lower the fed funds rate to 150 bps into next year, but will use its bullets wisely.

~Kalivas/Hoversen

### **EQUITY MARKETS:**

U.S. equities are expected to trade sideways through October. SPZ8 should range between 1100 and 1250. The market is expected to be supported by government action to stem the credit crisis. Congress is likely to pass the Troubled Asset Relief Program, and central banks are likely to relax monetary policy, globally. Moreover, there is talk of a relaxation in mark to market accounting rules which will take pressure off of bank balance sheets and the need to raise capital. These actions are occurring at a time of unprecedented panic. The VIX is flirting with historical highs over 40%. Usually stocks make a bottom in periods of extreme panic. Equity prices have typically rallied post a period where the VIX has traded over 40%. The financial sector has outperformed the broad market in recent weeks. The KBW Bank Index has outpaced the S&P 500 since July 15<sup>th</sup>, and has seen limited downside during the market's recent swoon. Financial shares usually lead the overall market and their stability hints that a bottom could be near. However, the weakness in the global economy is likely to strain profit growth outside of the financial sector. Disappointing earnings guidance from companies such as Research in Motion and Con-Way, and poor travel data points from Southwest Airlines and Marriot highlight a down beat profit picture. Earnings growth is poised to decline

through year end. On a more technical note, numerous investment funds are dealing with redemption and trapped assets at a well known bankrupt prime broker. Disruption on the buy side of the market along with negative profit news could make it difficult for the market to sustain a strong rally.

~Nick Kalivas

### **CURRENCIES:**

MFGR remains bullish the dollar as the global outlook continues to deteriorate. The macro picture in Europe is poor as unemployment accelerates in Spain and Ireland and Euro-Zone Manufacturing PMI falls to its lowest level since the conception of the index in 2006. Additionally, credit conditions are extremely tight. Three-month EURIBOR hit its all time high at 5.33% and European banks have opted to deposit money at the ECB rather than at each other's institutions. The Bank of Ireland has already guaranteed all deposits and Spain is considering a similar play. The climate in the UK is just as pessimistic. The BOE noted that unsecured lending to consumers hit a new low while household credit availability is the lowest on record. Housing prices continue to slide and the PMI manufacturing lingers in the low 40s. On the rate cut front, MFGR expects the BOE and the ECB to begin aggressive rate cutting cycles. The BOE should cut 25-50bps at the October meeting while comments from Trichet have officially opened the door for ECB eases.

In Asia, the growth picture is similarly despondent. In China, the Real Estate Climate Index is down -2.7% Y/Y and South Korea saw their FDI fall for the first time this year. Additionally, the Korean government decided to inject \$5B into the economies to help shore up small businesses. In Japan, the Tankan results as well as recent industrial production figures suggest that economic conditions will continue to weaken. Though the BOJ will likely not cut rates, the RBA will. The confluence of commodity price declines, a contraction in the Baltic Freight and a slowing consumer and corporate sector lay the groundwork for easier policy.

MFGR expects the dollar to continue its gains versus the EUR, GBP, and CHF. Additionally, the USD/CAD looks ripe for a breakout to the upside (especially as crude continues to setback). The USD/JPY has some downside risk. Though the growth and interest rate fundamentals favor the USD, the embedded risk component in the yen will make it favorable while global equity markets liquidate. Look for the USD/JPY to trade lower as the VIX remains elevated. Also expect additional weakness in EUR/JPY and GBP/JPY. Expect EUR/JPY to head towards 142-00.

~Jessica Hoversen

### **PRECIOUS METALS:**

Gold prices are expected to fall this month, with a test of the Sep low near \$740 anticipated. Silver should fall toward \$10/oz psychological support. While it's undeniable that gold provides an attractive source of safe-haven, MFGR believes that the need for safe-haven will fall in the next few weeks as credit problems diminish in the U.S. and grow in Europe. Congressional passage of the bank bailout plan should be simulative for the economy, and thus support the dollar and pressure gold. Similarly, the positive seasonal rally that takes place at this time of year due to stronger Indian demand may be muted by weaker Western demand and reduced hedge-unwinds by producers. Background pressure will come from continued index fund selling and from the supply/demand surplus. MFGR was unable on a sell rec on Oct 1st at \$900.00 by \$1.30, so best trade now is to trade the market from the short side, with an end-Oct objective at \$740 and early-'09 objective at \$698.

~Tom Pawlicki

### **ENERGIES:**

Crude oil prices are expected to fall over the coming month, with a downside objective near \$86.25. The market should continue to fall due to reductions in oil demand growth as well as strength in the dollar. Oil demand growth has been hit in the U.S. as well as in Europe and parts of Asia, as the economy has slowed on a global basis. The IEA has projected an oil supply/demand surplus in 2008 since its Mar '08 report. The dollar is expected to continue its upward trend based on the contagion of the credit crisis from the U.S. to Europe. The hint by ECB's Trichet on Oct 2nd that the central bank may cut rates also supports a stronger dollar. While the bank bailout plan is likely to pass the House this week, and should stimulate the U.S. economy, any growth in oil demand should be offset by a stronger dollar. Background pressure will come from continued outflows from commodities and less need for commodity-based safe-haven. Indiscriminant selling across the commodities complex has combined with reductions in net fund longs and open interest to suggest that index fund investment is moving on to better opportunities elsewhere. Our best trade is selling rallies in oil near \$110 and targeting \$86.25.

~Tom Pawlicki

### **GRAINS:**

Free fall through prior lows this week suggests further erosion to next support on weekly charts—specifically: CZ-\$4.25; SX-\$9.60; WZ-\$5.50. Velocity of price erosion ahead of one of the most important crop reports of the year underscores extent to which external capital flow dynamics are dominating the price discovery process. Fear of additional index fund liquidation will ward off bottom pickers while nudging end users into hand-to-mouth buying behavior that is unable to counterbalance fund selling. Meanwhile US and global farmers, that have grown accustomed to earning handsome storage returns following harvest in recent years, will be faced with merchandising grain in a tight credit/recessionary environment that could hasten producer sales prior to '09 planting. Globally, 08/09 wheat production is up 65 mmt, 08/09 grain production outside the US will set a new record (prompting a 5 mmt decline in global grain trade) and '08/09 FSU grain exports will be up 20 mmt over last year (or 15% of total global wheat/coarse grain trade). And with one of every 3 ears of US corn going into a gas tank, the corn market—which anchors the entire floor—will be further undermined if crude oil erodes to MFGR's \$78/barrel downside target. Grain markets may be overdue for an upside correction once 20-21 month grain rally unwinds (only 3 month correction so far) but speed and magnitude of LH '08 grain/oilseed sell off will temper re-entry of longs. Cash grain/oilseed values will approach producer variable cost of production levels unless supply scare unfolds in South America early next year. The October crop report next Friday will help determine not only '09 row crop acreage mix but extent (if any) of additional US acreage needed to achieve adequate '09 US carry outs.

~Rich Feltes

### **CRB:**

Plunge through CRB 450 area today suggests 400 on weekly charts. MFGR is bearish crude, gold, grains and hogs. General commodity liquidation continues amid fears of a

global recession, declining crude price forecasts by private sector (MFGR's initial downside target is \$78) and unfolding demise of passive commodity longs as a prudent investment strategy. Indiscriminate selling of all commodities regardless of their individual fundamentals is another warning sign to CRB longs. Failure of government initiatives to loosen credit along with MFGR's bullish dollar outlook will hasten capital withdrawal from commodities. Bottom line—slowing growth in global commodity demand along with investor desire to reduce portfolio risk portends additional CRB weakness into year end.

~Feldes/Kalivas/Pawlicki

## **TRADE RECCOMENDATIONS:**

**Debt Markets:** Buy September 2009 Short Sterling at 95.26. Risk 94.80. Target 96.25.

Buy September Euribor at 96.18. Risk 95.90 and target 96.75.

Buy September 2009 Eurodollars at 97.05. Risk 96.80. Target 98.00.

**Equity Markets:** Buy SPZ8 at 1102. Risk 1072 and target 1190.

**Currencies:** Buy USD/CAD on a set back to 1.0658. Risk 1.0514. Target: 1.1000

Sell EUR/USD on a set back to 1.4096. Risk: 1.4173. Target: 1.3250.

**Energies:** Sell CLZ8 at \$110.00, target \$86.25, risk \$113.00.

**Precious Metals:** Sell GCZ8 at \$880, target \$740, risk \$900.

**Grains:** Sell minor corrections in corn, beans wheat and CRB.