

The 3M Report. Monthly Market Memo: June 2009



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DEBT MARKETS: TYU is expected to work sideways to higher near term and the 2/10 curve should flatten in a corrective trade before widening again. However, the market is being run by technical factors and portfolio repositioning. Mortgage service and origination accounts have been sellers in recent days and the swap market has witnessed aggressive “paying” linked to the GM bankruptcy. These factors, along with risk taking, may have pushed prices lower than justified by the pace of economic growth and inflation. Looking at fundamental factors, the global economy is improving as PMI indices are working higher, but growth levels are still weak and a sharp rise in interest rates could derail the economic recovery. The May ISM new orders index rose 3.9 to 51.1, but the gain was a function of conditions stabilizing, not a major pick up in orders. The percentage of respondents seeing better orders fell 4 to 31. The housing market has firmed, but the recent rise in mortgage rates and continued inventory overhang will slow the recovery. Conventional mortgage spreads to treasuries are already historically tight. The consumer sector shows limited signs of improvement. Tax cuts/credits have raised disposable income, but have yet to lead to a major pick up in spending, and unemployment continues to climb. Mortgage delinquency data indicates that consumer balance sheets are still stressed and a limit to spending. The May unemployment rate is expected to hit 9.2% and 10.0% is becoming a realistic level given the trend in continuing unemployment claims, which are poised to work over 3.8 mln. Costco indicated little improvement in consumer spending, and Proctor and Gamble is talking about price cuts while highlighting a consumer preference for value. Inflationary pressures are limited despite the focus on the expansion in the Fed’s balance sheet.

Outside energy, inflation is tame with German, Japanese, Chinese, and U.S. CPIs printing negative year over year rates and the ISM price index still below 50 at 43.5. More importantly, Starbucks is looking to cut its store leasing costs by as much as 25% and home prices are in the early phase of stabilizing at best. Cheap land prices go a long way to reducing business costs. Heavy funding needs and poor valuation are the main negatives. The Treasury will issue \$65 bln in new cash via 3, 10, and 30 year auctions between June 9th and June 11th. More supply will come mid to late June when \$85 bln in cash will be raised via 2, 5, and 7 year auctions. Nominal treasury yields look low as risk tolerance normalizes, especially at the front end of the curve. The Baa/10 year spread has narrowed about 200 bps from its peak, but it remains wide in the 420 bps area. Additionally, equities are cheap to cash and the front end of the curve. The JGB/10 year UST spread is trading around the 219 bp area and may need to work into the 250 bp area before Japanese investors are more interested in treasuries.

~Kalivas/Hoversen

EQUITY MARKETS: SPM is expected to work sideways to higher in June. Prices are expected to test the 985 to 1000 area. A close below 915 would question the uptrend. The market is supported by a favorable technical set up, a backdrop of ample liquidity, and is cheap to cash. Moreover, the trajectory of earnings growth is improving given the upswing in the ISM index. The downside risks rest in a soft performance of the banking

sector and heavy issuance. The market could also be getting ahead of the pace of economic growth. The technical picture is bullish as stocks are breaking out of a weekly consolidation pattern to the upside, and investors are under invested. As the S&P 500 turns firmly higher for the year, money is likely to chase prices higher. Being underweight is no longer acceptable when stocks are posting healthy gains. There remains plenty of money on the sidelines given money market fund holdings and money market yields make stocks look attractive. The Fed's aggressive injection of liquidity has stabilized asset prices and argues for higher equity prices despite the deleveraging process over the last year. Many times, sharp gains in the monetary base lead to rising stock prices on a year over year basis. Over time, earnings per share rise with the trend in the ISM and the ISM appears to have bottomed. The downside risk to the market rests in heavy equity issuance. \$56 bln in new equity was issued in May and June is starting out with additional sales. Prudential, JP Morgan, and SunTrust have announced secondary issues worth approximately \$8 bln. Bank shares have been reluctant to rally and are underperforming the market on the recent upswing. Typically, financial shares are leading or coincidental indicators. Their inability to rally may be a sign the rally does not have lasting legs. Lastly, the outlook for economic growth is still dim. The current move is more cyclical based on inventory correction and pent up demand than lasting fundamentals. A sharp rise in interest rates could abort the recovery. Longer term, the economy's growth rate is jeopardized by uncertainty over cap and trade legislation, a national sales tax, and heavy regulation in the financial industry.

~Nick Kalivas

CURRENCIES: The trend lower in the dollar is likely to continue in the first half of June. As the global economy bottoms, the markets will favor risk and shift away from the greenback. There is much concern over the fiscal composition of the United States as the budget deficit-to-GDP ratio skyrockets and the treasury continues to issue debt at a record pace. Additionally on the heels of the UK's placement on credit watch negative, the market fears that the deterioration of the US's balance sheet has put the country in a compromising position. The hypocrisy embedded in the current administration's decision to expand the structural deficit but yet constantly comment on the necessity of responsible government spending, erodes near-term credibility. Finally, the current ascent in Treasury yields raises concerns that the Fed will have to expand its quantitative ease program. The Fed is \$130B into the \$300B, leaving a goodly piece yet to be purchased. There has been a misconception about the Fed's decision to QE. The bank never explicitly stated that they would defend a level in the 10-yr and surely is concerned about stepping up purchases and facing accusation of debt monetization. However since the March low of 2.35%, the 10-yr yield has rallied 44%. The upward pressure on interest rates has the potential to derail confidence and cap gains in equities as well as the global recovery. The Fed meets June 24th and unless Fed officials quell fears over the increase in purchases then the market will use this against the dollar. Despite these facts, MFGR does not foresee a dollar crisis, just a diversification into other currencies. The US is unlikely to be downgraded and see their status as a reserve currency change. This factor will help the dollar in the long-run as the focus turns to the PACE of economic recovery. The near-term decline in the dollar will be a benefit to the economy and US goods will be favored in the global trade. The pace of economic recovery is likely to be the catalyst to lift the dollar in the second portion of June. MFGR sees the Dollar Index trading down to 78.308 – 77.50 before reversing. Post the employment report and the ISM, the market may have to realize that the tempo of macro revival is overestimated. This will help support interest in the dollar. Though the headline ISM reported a gain in May, the details showed that expansion is occurring at a glacial

pace. Only 2 of the 18 reporting manufacturing industries reported growth in employment. Furthermore only 5 of the 18 reported total growth in May. The commentary in the ISM release also hinted at downward trending business. Deflation is also a global threat that is hardly waning. Its perpetuation will hamper recovery and make debt obligations ever more burdensome. On an entirely different front, geopolitics are back in play. Keep in mind how the market reacted to the North Korean nuclear tests: dollar buying.

Looking at the European currencies, the EUR/USD looks ripe for correction. However, the cross has solidly broken through the 1.4000 psychological level and has breached the 50% Fib retracement line 1.4184 (July 07 high to 10/08 low) which is also the 76.4% Fib retracement from the Dec 08 high to the Mar 09 low. The ability to stay above this level should help propel the cross to 1.4445 to 1.4500. If the cross breaks out of the upward channel, MFGR expects the pair to test the 1.4719, the 12/08 high. The German Unemployment numbers showed that the pace of job loss in Europe FOR THE TIME BEING has slowed and the PMI also showed improvement. Additionally, the ECB is likely to remain unmovable on policy in June. These factors will provide fundamental support. However, real rates in Europe are at 1% which is entirely too high given the economic conditions. If disinflation persists, look for the ECB to cut in the future, a long-term bearish factor. The GBP/USD has momentum but the technical indicators are pointing toward a pull-back. The 50% Fib from the Sep '08 high to the Jan '09 low at 1.6080 will stand as support. The next level of psychological is 1.6500. MFGR would buy a breakout of that level for a target of the Fib retracement 1.6696.

MFGR sees the main losses versus the dollar to continue in the commodity currencies namely AUD, NZD and CAD. The moves do look overdone but as long as investment money which has been sitting on the sidelines for months keeps flowing into commodities, then these currencies will benefit. The Chinese growth story still supports the economic recovery thesis. However, the Chinese PMIs were mixed. The survey set up by the China Federation of Logistics and Purchasing and National Bureau of Statistics fell and looks as though it is starting to roll over. Though investment flow into commodities is still strong, this data suggests to walk carefully on thin ice.

Finally, MFGR sees the yen trading weaker in June. The most recent trust data showed that Japanese investors are aggressively moving into foreign securities. MFGR is a seller of the yen against all majors. USD/JPY will gain momentum over the 200-day moving average, clearing the path for a move to 100-00.

~Jessica Hoversen

PRECIOUS METALS: Precious metals are expected to trade firmly in June, with gold prices advancing above \$1,000/oz and silver above \$16.00/oz. While both markets are undoubtedly due for a downside correction, we view the longer-term picture as still favorable for precious metals. Economic data has turned mixed over the past few weeks, but treasury yields have risen due to excess amounts of gov't debt issuance and record budget deficit projections. Yields have risen in spite of massive buying of treasuries by the Federal Reserve. The dollar has weakened as a result, leading metals markets with a strong fear of inflation. Metals will benefit from investment inflows, although at times they may compete with attention from equities. Non-commercial accounts added over 47,300 contracts to their net long in gold since mid-Apr and over 14,000 in silver. ETF's have seen increases in holdings in funds offered by European-based issuers.

Investment has moved into bullion as well, where premiums have risen on bullion coins. Total commodity assets under management have increased to \$180B from \$160B at the start of this year after peaking at \$200B in mid-2008.

~Tom Pawlicki

ENERGIES: Energy markets are expected to trade in a mixed-to-higher direction in June. Oil prices should approach the \$76.30 resistance level with support coming from investment inflows, technical factors, and by growing tensions with North Korea. Gasoline is expected to stabilize in a sideways trading range due to a negative seasonal pattern, while heating oil maintains an upward direction. Rising oil prices and higher interest rates suggest that the U.S. economy is recovering sharply, which is something that hasn't been entirely reflected in economic data. Instead, investment has risen substantially due to increased risk appetite and the rebirth of hedge funds. Non-commercial accounts have added over 54,700 contracts to their net long in crude oil since mid-Apr. Total commodity assets under management have increased to \$180B from \$160B at the start of this year after peaking at \$200B in mid-2008. The buying has caused the contango to narrow, which in turn, has decreased the incentive to maintain floating oil storage. Around 10 mln bbls in the Gulf of Mexico have been offloaded and imported to the U.S. despite ongoing weakness in demand. The resulting higher level of imports, along with signs of OPEC overproduction suggest that oil inventories may have difficulty in exhibiting seasonal declines. Regardless of bearish fundamental indications, investment inflows, the recent breakout above the 200-day MA and signals of additional missile and nuclear weapon tests by North Korea suggest that oil prices will remain buoyant.

~Tom Pawlicki

GRAINS: Impressive 1st of month Ag market price gains in absence of any new bullish developments underscores dominant role inflow of new capital is exerting on price discovery. Ag markets, despite abundant US moisture supplies, above average start for majority of '09 US row crops, red ink in US ethanol/livestock sectors and prospects for gains in 7/10 US/global wheat stocks are on the verge of posting new calendar year highs in grains while soybeans broach the highest levels since late Sept '08. Grain markets are routinely ignoring bearish news and over-reacting to bullish news while soybeans are staging an orderly advance in response to potential over-commitment of old crop US soybean exports and strong incentive for US crushers (via high crush margins) to maximize old crop crush. All markets will be extraordinarily sensitive to summer crop adversity with CZ/SX summer rallies of 40 cents/\$1.00 respectively common since 1990. (CZ/SX rallied \$1.30/\$1.95/bu respectively last summer). Prospects for cool temps June 1-15 throughout upper Midwest will be viewed constructively by traders already nervous over slow start to eastern Midwest growing season, unrealized corn intentions, a much dryer than normal May across portions of western Midwest and delayed HRS planting. Positive row crop charts and orderly nature of soybean rally suggests SN 12.80-\$13.50 portending CN advance to \$4.90-\$5.00. Late June '08 CN/SN highs were \$7.60/\$16.63 respectively. Technically wheat projects to \$8.10-\$8.30 (vs. 2/08 high of \$12.95) although a \$1.50 rally in wheat is difficult to justify unless '09 N. American HRS production is seriously threatened. Advise buying 20-40 cent breaks in soybeans and buying 10 cent breaks in CZ (which penetrated 200 DMA today). Look for wheat to peak 1st (wheat erodes seasonally LH June/FH July)

while corn and soybean 30 year seasonals typically top out 6/23 which corresponds to beginning of countdown to high risk June 30th acreage report. Bottom line—buy row crop breaks but reassess position after '09 US row crop acreage mix and FH July weather pattern are clarified after June 30th crop report.

~Rich Feltes

CRB: Early May '09 CRB upside breakout poised to follow through in June with 450 as next upside target. Our constructive commodity outlook is buttressed by expectations for continued dollar weakness, accelerating capital inflow to commodities and a late June crude oil price objective of \$70-\$75/barrel. Unlike the exotic financial investment vehicles of recent years that are now considered high risk and opaque, commodities as an asset class are liquid, transparent and highly regulated. A reduction in legitimate investment vehicles suggests that primary asset classes (equities/bonds/commodities) will each attract more capital. Furthermore, commodities are still perceived as cheap having corrected only 1/3 of LH '08 losses with more evidence that emerging Asian economies are stockpiling commodities at perceived bargain price levels. From a sector standpoint, soybeans still have upside potential if US demand doesn't abate soon or if '09 US soybean yields are threatened while corn will remain supported until critical June 30th acreage report. Meanwhile, precious metals will be buttressed by reduction in foreign accumulation of US debt and public clamor for hard assets in an era of exploding US budget deficits. Look for steady to higher livestock markets this summer—ditto for base metals. Conclude that while commodity pricing is out ahead of fundamentals, increasing investor appetite for commodities is unlikely to falter until lower than expected economic performance turns CRB lower thus reducing capital flow.

~Feltes/Kalivas/Pawlicki

TRADE RECCOMENDATIONS:

Debt Markets: Buy TYU July 116-00 call @ 45/64. Risk expiration and target 2-00.

Equity Markets: Trade Idea: Buy SPU at 931. Risk under 915 and target 985.

Currencies: Buy DXY at 77.50. Target: 81.00. Risk: 75.80
Sell AUD/NZD at 1.2500. Target: 1.2200. Risk: 1.2600.

Energies: Sell Buy CLQ9 at \$65.00, target: \$75.00, risk \$62.00.

Precious Metals: Buy GCQ9 at \$960.00, target \$1033.00, risk \$940.00

Grains: Buy SX and CZ on breaks.

CRB: Buy CRB on breaks.