Some Macro Strategies June 2009

Part of the recovery and healing process of the world economy will involve an evolution of the trade positions of countries. As profligate nations save and emerging market consumers expand, Western trade deficits and emerging market trade surpluses are likely to contract towards balance. The transactional demand for currency will likely support the USD and EUR while CNY, JPY, KRW, INR weaken.

Commodity exporters are likely to see stronger currencies as well, thus AUD, CAD, ZAR. These are longer term themes and short term volatility and news may recommend trading ranges and channels. The risk aversion trade in CHF and SGD is also likely to recede over time but provide interesting range trading opportunities.

The inflation – deflation trade is an interesting opportunity also. From time to time, the market will switch between believing that the world will end in fire, and believing that it will end in ice. With short term interest rates fairly well anchored in the medium term, this will manifest mostly at longer maturities.

For the last 3 months markets have been pricing for inflation. Most yield curves have steepened considerably. A reversal is due both technically and fundamentally. A US treasury flattener, short 2 years long 10 years at a spread of 2.55% is an attractive trade betting that deflation fears will re-emerge and the 10 year will rally. The same trade can be replicated in EUR. This theme is very tradeable as the market fluctuates between inflation and deflation with the added pressure of high volumes of issuance versus uncertain take up from foreign and domestic investors. This spread trades in a range of 1.50% to 2.60%.

The oil and gold trade is one I have followed for some time since oil was 0.16 quanto gold in ounces. At 0.06 oz, oil was a strong buy (relative to gold.) At current market of 0.078, it is also still a buy, however, current market sentiment is likely to see a better entry point. The 6-12 month target for this trade would be 0.12 oz. The range for oil quanto gold is intact. The buying opportunity came from a global de-risking. Despite increased inventory, and this through the recent rally, oil remains a strategic asset. The range established since the second intifada in 2000 is holding well and I expect to continue to hold until strategic developments in the Mid East relax the need to the West to stockpile strategic reserves. On a USD pricing basis, 60 – 70 USD seems to be a sensible range from a demand perspective.

The trade expression in equity markets is more problematic given that there are more moving parts and idiosyncratic risk gets in the way of macro level trades. I am of the view that underlying economies had decoupled by last year even if financial assets had not. We didn’t see the decoupling because asset markets were correlated by ownership. The BRICs were and continue to be export economies and are thus coupled to their trading partners in the West. This coupling is weakened and weakening. The utter slump in global trade is accelerating this process. The West simply has not the capacity to resume pre 2008 levels of consumption. On a relative basis, the trade positions of the West versus the

BRICs must change, transforming the BRICs into domestically driven economies. The immediate natural tendency for the private sector is to retrench. Fortunately the state has the wherewithal to fill in the gap and support the process of transition. This is not true of Western state balance sheets. Long growth short value strategies in the BRICs hedged against long value short growth in Western markets is probably a good idea. An outright long BRIC short Developed market is not the best idea because of the relatively higher volatility of the BRIC markets. Trying to hedge both the beta’s and the volatility leads to inconsistent results.