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The 3M Report.
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DEBT MARKETS: Ten year futures are expected to grind higher. The market will be supported by still weak economic conditions, the working out of credit stress, and lingering deflationary pressures. Supply and competition from higher yielding assets remain the biggest negatives. Although the ISM index is working higher, it remains below 50 and strength has been driven by inventories stabilizing after extreme de-stocking. End demand is soft. Consumer spending faces on going headwinds. Mortgage refinance activity has slowed, fuel prices have risen from their late winter low, and wage growth is limited. Wage and salary growth has sequentially declined seven of the past eight months. Government transfer payments have been the key factor supporting personal income. The weakness in wage and salary growth is causing consumers to trade down and shop around paycheck dates. Moreover, credit card costs are rising with key banks rising interest rates and minimum balance payments. The housing market appears to have bottomed, but the recovery is more in an "L" shape than a "V" shape. Lennar's CFO said that the housing market was in for a rocky road in the short term, and foreclosure supply remains enormous. Commercial real estate remains under stress with the value of hotel property defaults in the second quarter almost double the first quarter's pace around $17 bln. Weak same store sales growth and defensive retailers are pressuring mall demand, while auto dealership are closing providing extra land capacity. The Architectural Billing index is below 50 and implies weak commercial construction activity into year end. Midtown Manhattan office vacancies for Class A space is at a 15 year high at 15%. The government sector is also a drag to economic activity with taxes and user fees rising to plug surging deficits. Layoffs are also present. Credit conditions remain difficult. Even though LIBOR has normalized, Fitch said credit card losses hit 10.44% in June and were up 62% from a year ago. Inflation should be subdued as there is ample slack in the labor market and capacity use rates are historically low. Pricing power is limited with consumers value shopping. Real estate prices continue to fall with existing home and commercial real estate prices down. Moody's commercial real estate index was off 8.6% m/m and 25.3% y/y in April. On the bearish front, there has been a willingness of investors to take risk. Corporate credit spreads have been contracting, although the BAA/10 year spread is approaching support at the 345 bp level. Equities have also seen improved interest in recent weeks with ex-ETF mutual fund inflows over $15 bln. The Treasury will be raising about $125 bln in new cash via straight coupon issues this month. The heavy funding need and on strength in corporate debt issue are lifting rates. $121.9 bln in corporate debt was sold in June compared to $68.9 bln a year ago and $142.4 bln in May.

~Kalivas/Hoversen

EQUITY MARKETS: Stocks are expected to trade flat to lower during July. Weakness is most likely in the second half of the month after Q2 profit reports begin to be released. The market will be supported by two factors: First, there are signs of improved economic growth. Globally, PMI numbers are steadily climbing and indices have established troughs. Historically, profit growth has tracked with the direction of the ISM survey. A recovery in economic growth is being driven by more balanced inventories. Only 15% of those answering the ISM survey said inventories were too high. Second, stocks are cheap to cash and investors have been willing to take risk in a search for return. Between mid March and late June, money market fund asset levels declined almost $200 bln pressured by near zero short term rates. The flow of money out of money market funds has also improved conditions in the corporate debt market and helped to support equity valuations. A normalized 3 month LIBOR rate, and falling credit spreads underscore a slow healing of the financial markets. The downside risk to the equity market is present in cool Q3 profit guidance and socialist policies which could freeze hiring and investment spending. Companies are likely to be cautious about projecting healthy Q3 profit growth, and could leave the market overpricing the economic recovery. Global trade remains anemic and consumer spending is facing the headwind of higher mortgage rates, firm gasoline prices, and a restructuring of state and local governments which are raising taxes and paring jobs. Furthermore, banks are increasing the cost of credit card use. Citigroup recently boosted the credit card interest rate by 300 bps for 15 mln users, while JP Morgan has raised the minimum level of monthly repayment. The potential for a tax on healthcare benefits, and stringent cap and trade legislation could also weigh on consumer and business spending, while hurting investor confidence. Seasonally, July has tended to be a slight positive month for the S&P 500. Prices have risen 44 of the last 81 years or 54% of the time going back to 1928. The average increase has been 1.39%. However, prices have only increased three of the last ten years during July for an average loss of 1.54%. Over the last two years, July has witness adverse credit events.

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~Nick Kalivas

CURRENCIES: The dollar is expected to trade sideways to higher in July. MFGR offers three reasons for the continued rally of the dollar.

1. There is a growing recognition that the economic recovery has been overpriced and that the globe is facing macro stagnation. Though the pace of contraction has slowed, the recent round of data exhibited further deterioration. THE US ISM expanded less than expected and the Chinese PMI ONLY increased .1 to 53.1, an increase inconsistent with the idea of robust macro revival. On top of this global trade continues to stumble due to the increase in mercantilist tendencies. The markets are at an inflection point and price action at the end of Q2 reflected the hesitancy. In retrospect the market euphoria seen last quarter was more of a reaction to lack of decay and stabilization rather than fundamental economic growth. Though Q2 earnings may be constructive, earnings growth does not necessarily correspond with solid economic activity. Cost cutting activities and the base effect will help boost the earning picture but the guidance will reflect the corporate perception of the demand picture. Given the employment data, MFGR can't imagine the tenor will be profusely rosy. Though the ISM Manufacturing Employment data moved back over 40, the ADP number showed a much larger than expected decline and the continuing claims data is still uncomfortably high, arguing for on going increases in the jobless rate.

2. The Fed looks like a hawk in a cage of European doves. The ECB exited June with a bang. Following the commencement of the ECB's 1-yr unlimited funding facility, the ECB's balance sheet is $2.796 trillion after converting into dollars at an assumed exchange rate of $1.40. That is $744B greater than the Fed's. This vast amount of money reflects the European's attempt to be covertly dovish. True, they

are not coming out and cutting interest rates to zero like other central banks. However, they are providing unlimited funds at 1% for an entire year which suggests to the market that is where the ECB believes the equilibrium for longer-term money market rates rests. Furthermore, the high demand for these funds suggests that the problems in the European banking sector are likely greater than original estimated.

3. Intervention threats are real. The SNB has been very active in selling the franc causing a 2.5% rally in EUR/CHF on 6/24/09. The SNB has been candid about their intention to intervene and while they have been ambiguous about their trigger to act, price action suggests that the 1.5000 level is key. Currency manipulation is also a risk in AUD, NZD and CAD. Central bankers from these three countries have been vocal about the negative impact imposed on exports due to currency appreciation. Additionally, intervention is not unprecedented on these shores.

There are however risks to the dollar. The main risk is a political one. President Obama's initiatives are anti-growth as the administration's plan to pay for them by taxing middle and upper classes. Government transfer payments now make up 1/6th of personal income putting US entitlement programs on an unsustainable course. Robin Hood economics will not be viewed positively by the market and an unfavorable tax structure will deter capital away from the US.

Secondly, the dollar index is still trading in a downward channel. The index behaved perfectly in June, bouncing offing the lower bound of the channel. Given the chart pattern there is a risk that the dollar will find technical pressure from the upward bound of the channel.

Thinking about the commodity currencies, CAD retraced almost 8% in June and much like the S&Ps, NZD and AUD stalled in the latter 1/3 of the quarter. The numbers in AUS and NZ have been weaker (Aussie Building Approvals -12.5% and NZ GDP fell -2.7% Y/Y). All three are vulnerable to depreciation given their current correlation with the pace of the global recovery.

~Jessica Hoversen

PRECIOUS METALS: Precious metals are expected to hold in a relatively sideways range this month, as trade appears to have reached short-term equilibrium amid lower summer volumes. Gold prices should hold near the $913-$949 range established in the last half of June while silver holds between $13.50-$14.50. The equilibrium in metals prices is also reflected in the dollar, which has held steady in the second half of June. On one hand, the U.S. gov't has exhibited no inclination to reduce spending, and is considering a second bailout package after the first has imparted little fruit. Such spending has provided ammunition to gold bugs who have for years railed about the dollar being a fiat currency. Excessive gov't spending dilutes the value of the dollar and makes gold more attractive. On the other hand, the economic recovery is leveling off in our opinion, and could create dollar support from a safe-haven basis. The phrase "green shoots" has been used much less lately than was the case in April & May. The economic recovery will be hampered by policies out of Washington including the cap and trade plan, national healthcare, national VAT, violation of contract rights, and favoritism of unions. With higher taxes in store over the next year for most Americans and doubts about the security of bondholders' rights, incentives to spend or invest are limited. A resulting higher dollar would be negative for precious metals. Further pressure could come from an expected end to Chinese restocking, which would also cast a shadow over perceived economic growth.

~Tom Pawlicki

ENERGIES: Energy markets are expected to hold in a relatively sideways range this month, as trade appears to have reached short-term equilibrium amid lower summer volumes. Oil prices should hold in the $67-$74/bbl range established during the second half of June. Energy markets will be torn between support from investment and pressure given by the economy. Large funds have added 54,000 contracts to their net long in crude oil since mid-Apr and investment tracking commodities has been estimated to be around $210B, growing $22B this year. Additionally, large brokerage firms that offer commodity index contracts have recently raised price objectives, thus indicating that more investment is possible. The negative side will be dominated by bearish fundamentals and our expectations for a weakening economy. Total U.S. oil demand is -9.3% from a year ago and compares to -11.6% at its worst levels in early-May. Granted, a recovery in demand has taken place, but it certainly hasn't been robust. Similarly, the recovery in the economy is expected to level off and could create support for the dollar on a safe-haven basis. The phrase "green shoots" has been used much less lately than was the case in April & May. The economic recovery will be hampered by policies out of Washington including the cap and trade plan, national healthcare, national VAT, violation of contract rights, and favoritism of unions. These measures come as European govt's discuss ways to exit their stimulative policies. Further pressure could come from an expected end to Chinese restocking, which would also cast a shadow over perceived economic growth.

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~Tom Pawlicki

GRAINS: Today marks the kick-off of the most important 60 days of the North American growing season. Advise trading the soybean market from the long side on breaks, selling wheat on rallies and avoiding corn shorts until after pollination. The soybean market, dealing with tight world supplies, record PRC soybean imports and limited forward coverage by other soybean importers, will remain well supported until trend or higher '09 US soybean production is assured (late July at the earliest). New SX highs are probable even with small doses of adverse July weather. Scarcity of US soybeans during next 90 days will ease with approach of largest US soybean harvest in history. But in the short term, soybeans prices will be contra-seasonally firm as market accesses intensity of late summer scramble between processors and exporters for smallest soybean supply since 2004. Additionally, soybean price discovery will key off fate of late planted soybeans in eastern Midwest and developments with dry/warm pattern setting up in Delta & lower Midwest where double crop soybeans are concentrated. Wheat will be pressured by prospects for July to Final gains in US all wheat production, ample foreign exporter wheat stocks, dismal US wheat export sales and ample export offerings whenever hand-to-mouth importers issue tenders. Our reluctance to sell corn is predicated on prospects for threatening weather after July 10 crop report. Additionally, there is a strong historical tendency for 30-50 cent summer rallies in CZ. Longer term (late July onward) we are negative corn due to higher than expected '09 US corn acreage and eroding corn demand from livestock. Look for corn market to drift to full carry-especially after pollination when 2.0 bil bu + of old crop US farmer owned corn starts moving. Additionally, trend following funds with large corn longs are faced with dismal chart action and a negative LH July seasonal. Advise long CZ/short SMZ in mid July when weather uncertainty typically wanes. Also advise long oats/short corn, long SF/short SK, long KC/short MLS wheat and long 1 SX 10/short 3 CZ 10.

~Rich Feltes

CRB: Anticipate choppy to lower trade headed to support in 380-370 area. Crude oil is expected to range trade in $67-$74/barrel area amid ongoing clash between tepid fundamentals (ample supply/weak demand) and inflow of risk capital interested in base positions in energy markets prior to economic recovery which is unlikely to occur until Q1 2010 at the earliest. Contrary to cautious optimism exposed by the Administration, key economic indicators remain negative including low ISM readings, steel mills operating below 50% of capacity, low level of rail freight traffic and zero growth in jobs and investment spending. In short, economic indicators do not support accelerating demand for commodities even in India and PRC where stimulus programs have witnessed more success in generating domestic spending than spawning growth in export demand. Additionally, escalating trade friction, where the US has abandoned its leadership role in reducing trade barriers, is viewed as negative for global economic growth. From a sector standpoint, MFGR sees gold eroding to $900 area on heels of reduced demand from India/Middle East and waning investment inflow. Look for grains to trend lower in absence of adverse weather while soybeans sustain historically elevated price levels until trend or higher '09 US yields are assured. Livestock should be a bright spot for bulls in July with steady to higher hog prices amid shrinking supply and higher demand (lower priced pork is now competing with poultry) while cattle prices firm on prospects for lower weight gains on hot weather in plains. Bottom line—prospects for 4th consecutive weekly decline in CRB suggests more weakness in July with investment managers focused more on vacations than taking on added risk with an asset class that has faltered since June 1. Sell rallies.

~Feltes/Kalivas/Pawlicki

TRADE RECCOMENDATIONS:

Debt Markets: Buy FVU at 114-19. Risk under 114-00 and target 116-16.

Equity Markets: Sell SPU at 949. Risk 972 and target 885.

Currencies: Short EUR/USD at 1.4338. Target 1.3750. Risk:1.4500

Energies: Buy CLQ9 at $65.00, target: $74.00, risk $63.00

Precious Metals: Buy GCQ9 at $915.00, target $949.00, risk $890.00

Grains: Advise long CZ/short SMZ in mid July
Advise long oats/short corn
Advise long SF/short SK
Advise long KC/short MLS wheat
Advise long 1 SX19/short 3 CZ 10

CRB: Sell rallies.