

The 3M Report. Monthly Market Memo: September 2009



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DEBT MARKETS: The 10 year treasury yield is expected to work lower through most of September. Seasonally, 10 year futures have tended to rally during the first half of the month. Although the Treasury's funding need is large and inventory accumulation will stabilize economic growth, inflationary pressures are limited and uncertainty over global growth will provide support. The Treasury will continue to sell record amounts of debt and September coupon issuance will be nearly \$180 bln. However, auctions have found solid demand and concerns over a buyers strike have eased. Congress will reconvene September 8th, and the free spending Congress and a sympathetic Obama Administration could undermine investor confidence with another pile of debt, but the movement toward socialized healthcare has lost momentum. Polling numbers for both the President and Congress are falling quickly and work against a major expansion in government. The corporate debt market has seen a reduction in issuance and is providing some offset to the heavy treasury issuance. Economic activity will be supported by inventory replenishment. The ISM spokesman Ore indicated that the August PMI was consistent with 3.7% GDP growth, and the recovery was broader than autos. However, these positives are offset by expectations for weak back to school spending and lackluster consumer demand during the holiday season. Consumers continue to retrench and value shop. Materialism has taken a back seat to doing without. Additionally, the expiration of cash for clunkers will dampen auto demand, and incentives for appliance purchases will not sustain growth deep into 2010. Government programs are pulling forward growth and leaving the trade skeptical of a self sustaining recovery. Internationally, China is cutting down on bank lending, which fueled a H1 2009 boom, and global trade flows have been anemic. German employment subsidies are set to expire in the coming weeks and may undermine already weak European consumer spending. Inflationary pressures are limited. Major inflation indices are showing no inflation over the past 12 month period, and corporations have cut costs, while working to bolster productivity. TIPS break even level confirms extremely low inflation expectations. On a relative basis value, agency and mortgage spreads are tight and will help to cushion treasury prices. The biggest downside may be a move by the Fed to reduce liquidity by cutting back MBS or agency purchases.

~Kalivas/Hoversen

EQUITY MARKETS: Equities are expected to trade sideways through September. The market faces a mixture of cross currents. Bearish sentiment is high with professional traders skeptical of the rally and the sustainability of the economic recovery. Even retail investors have been cautious. The AAI poll's bull index was 34 and its bear index was 49 at the end of August. The spread of -15 is on the lower end of the historical range and more consistent with a mature sell off than a market top. Memories of last year's vicious market sell off and seasonal weakness are on the minds of traders. Historically, stocks have posted their worst performance of the year in September. Furthermore cash levels in money market funds are unusually high and could easily fall \$200 bln to \$250 bln before normalizing. Low money market yields and a 3 month T-bill rate below 15 bps leave stocks cheap to cash and will help to pressure corporate bond yields supporting

equity valuation. Even though stocks look cheap to cash, M&A activity has been anemic and suggests a richly priced market. However, M&A has shown signs of picking up in recent days with the Disney/Marvel, and Backer Hughes/BJ Services mergers. Likewise, EBAY was able to find a buyer for Skype (\$2.75 bln). Even though M&A has been lackluster and questions the market's value, new issue has slowed and the calendar appears light at this juncture. The profit picture is confused. Year ago comparisons are becoming easy, and will make for healthy earnings growth into Q4. Companies have controlled costs aggressively and any revenue growth will quickly flow into the bottom line. The ISM index suggests that the economy is expanding and the inventory cycle will bolster economic activity. Signs of improved economic growth are confirmed by Intel's upward guidance to Q3 revenues, and Rockwell Collins saying business jet demand is improving. When the ISM survey's implied projection for economic growth are combined with company cost structures, profit growth could surprise to the upside. Additionally, the financial sector will be able to generate strong profits from wide carry. The steep yield curve will help offset credit loss in commercial real estate. The downside to the market rests in the high chance that back to school spending will be weak and the demand for homes and autos will slow when government purchase incentives expire. The outlook for self sustaining growth is questionable as consumers continue to retrench and rebuild balance sheets. The political environment is less bearish as the nationalization of healthcare and cap and trade have lost momentum, but neither idea is dead and the AFL-CIO is calling for a transaction tax on equities. A log jam in Congress post the September 8th return will benefit the market.

~Nick Kalivas

CURRENCIES: MFGR believes the trade will have a two part tone in September. MFGR expects the dollar to trade firm in the first part of September. A correction in the global equity markets has been overdue and risk aversion argues for such submission to be dollar and yen favorable. The sell-off in the Chinese stock market, the 5% decline in EUR/JPY since 8/10, the overextended rally in US equities despite sequential losses in revenues and the recent limited positive reaction in US equities to better economic data have all acted as harbingers to another market capitulation. On top of all of this, financial risks have started to resurface with concerns over the FDIC's reserves and cries elevating over the health of the German banking system. The German government fears that some industries may face as massive credit squeeze if banks don't become more liberal with their reserves. It should be noted that Germany's Economy Ministry has announced that it will take steps to begin mitigating risks. As of now the state has agreed to provide state guarantees worth E7.5B. The German government is also making E10B available for KfW to provide loans directly to banks. On the global front, the fears of a total retrenchment in China and signs that the pace of Asian recovery is cooling make the market question the sustainability of the recovery. It is well accepted that that government stimulus helped filled the void left by the private sector. But as programs used to aid the consumer sector expire (German and US cash for clunkers and US new home buyer credit), the market must question what will drive the recovery in the remainder of 2009 and through 2010. Additionally, though there have been some signs of hiring activity, the unemployment rate is 9.4% and could possibly go to 9.5% with the release of the August Non-Farm Payrolls data – a factor that will leave angst in the consumer sector high and spending activity anemic. Truth be told, there is a bit of a fundamental argument for the dollar as well. The ISM popped above “50” for the first time since January 2008. Additionally, durables, new home sales and consumer confidence point toward recovery. There are foreign concerns that may also favor the dollar. On the sterling shores, the major headwinds for the GBP continue to be the

government's very loose pocketbook and unfavorable tax regime. On top of that the UK Manufacturing PMI dipped in August. The yen also possesses an interesting dynamic. The changing of the guard from the LDP to the DPJ was initially lauded by the market but the domestic exporters may begin to complain as the yen strengthens in the wake of the election. The DPJ has indicated that it will not intervene in FX markets. However, the new administration may pull forward costly social reform projects that elevate concerns over the budget deficit and inadvertently cause a depreciation of the yen.

The latter half of September will bring dollar weakness for four reasons.

- 1.) The first of these reasons is risk appetite. If the S&Ps are able to sell off to the very significant 950 level, there is likely to be a lot of money interested in stepping in and buying. Remember there is still some \$3.5 trillion sitting in money market funds waiting to be reinvested. Additionally, if the data keeps improving during this equity downturn (jobs data, ISM Non-Manufacturing, housing data), the market will feel more confident about the recovery.
- 2.) Secondly, Congress returns to the Hill on September 8th. If health care picks up steam, the fears over the budget deficit could provide major headwinds for the dollar.
- 3.) Global short term interest rate differentials make the dollar the new carry currency. Looking at US LIBOR versus the LIBORs of all the G-10s and Switzerland, US LIBOR has the lowest rate. Keep in mind that the globe is waiting for a leader in terms of monetary policy and it appears as though rates are going to low for a very long time. The market expected the RBA to be more hawkish and they disappointed. Norway may be the first of the G-10s to begin the tightening cycle given their fundamentals and the US may be one of the last given the historical pattern of US tightening cycles.
- 4.) A very impressive dollar seasonal suggests that the dollar trades sideways to higher from the 175th trading day of the year until the 185th trading day of the year. **The trader should then sell the dollar index on the 185th trading day and buy the dollar index back on the 196th trading day. The 185th and 196th trading days are traditionally the middle and end of September respectively. This year the 185th day will be September 14th and the 196th trading day will be September 25th.** Historical data shows that in the last 28 years executing this trade yields a profit 78.6% of the time. The average profit is 1.45% and the average loss is .91%.

~Jessica Hoversen

PRECIOUS METALS: The gold market is expected to move in a sideways-to-lower direction this month, with a break toward \$900.00 possible. Confidence in our bias isn't very strong, as negative fundamental factors have been ineffective against speculative buying for much of this year. Pressure will come from weak fundamentals and a meager outlook for inflation. On August 19th, the World Gold Council reported a Q2 '09 supply/demand surplus of 195 tonnes and revised upward the Q1 '09 surplus to 163 tonnes from 115 previously. Prospects for physical demand aren't great going forward, as Indian imports published on September 1st were -86% y/y while Turkish imports were -74% y/y. The high demand season in India is in September and October this year, but high prices and monsoon rainfalls that are 23% below normal will inhibit buying enthusiasm. Economic focus could shift past the current recovery and toward the expected slowdown in FH '10 that's predicted by economists and multiple Fed members. Support for gold will come from a strong seasonal pattern, which typically sees its best gains in September, November, and December. A long-term triangle pattern drawn over the past six months of trade will be the most important factor to watch technically, with

current boundaries at \$935 & \$975. While the pattern is a positive one because it follows the October '08-February '09 uptrend, an upside breakout is not assured.

~Tom Pawlicki

ENERGIES: Energy markets are expected to trade in a sideways-to-lower direction in September, with CLX9 holding below key technical resistance at \$75.89/bbl (Aug 6th high). We look for gasoline to fall toward \$1.60/gal due to a bearish seasonal pattern and a bearish oscillator divergence between the June & August highs. Heating oil, on the other hand, could remain range-bound between \$1.80 and \$2.00/gal due to positive seasonal patterns and despite high inventory levels. Pressure on oil prices should dominate and be applied by the equity market, China, and the CFTC. Seasonal patterns in U.S. equities are negative during the month of September, and the oil market's close ties with equities could put pressure on oil. Likewise, Chinese issues could be negative as well, with the government recently announcing that it will study ways to curb overcapacity in industries and restrict bank lending. Combined with the pullback in commodity restocking, intense focus will be on the Chinese stock market and whether the August 4th high will be maintained and the "bubble" continues to deflate. Finally, the threat of new CFTC regulations aimed at reducing participation by passive long index funds could create selling with the intention of reducing holdings below new position limits. The only major positives for oil prices will be the seasonal pattern and year-on-year comparisons in oil demand. The oil seasonal pattern is positive through mid-October, and oil demand will improve considerably on y/y comparisons with 2008 due to the collapse of Lehman and oil demand in September '08. OPEC is likely to emphasize compliance with existing production quotas at its Sep 9th meeting rather than make any output changes.

~Tom Pawlicki

GRAINS: Corn & wheat will erode to new lows into October 9th crop report given normal US Midwest Autumn frost dates. Our initial downside targets on CZ and WZ are \$2.90/\$4.35 respectively. Both contracts will erode even lower if normal/above normal September temperatures converge with 1st frost dates 7-10 days later than normal prompting a final US corn yield of 165 BPA+ resulting in 2.1 bil bu or higher 9/10 US corn stocks. Corn and wheat are unlikely to earn deferred carries. On a seasonal basis, corn typically erodes during September while wheat erodes LH Sept after firming into September crop report. Final '09 US corn and soybean yields have the potential to exceed current expectations by a wide margin but not without largely frost free growing conditions into mid October. The soybean market will be more challenging given lack of confidence in final '09 US/PRC soybean yields, record Q1 US soybean demand and a depleted old crop US pipeline. Nonetheless, burden of proof will be shoulders of soybean bulls if frost free weather into late September is confirmed by 11-15 day forecasts issued in mid September. Our initial downside objective on SX is \$9.15 followed by \$8.80 if widespread frost is preempted until mid October. Seasonally, soybeans typically erode after the September crop report (recall that SX '09 rallied LH August in keeping with seasonal tendencies). Ample supply of low priced wheat globally suggests that USDA may be overstating '09/10 US corn demand. Reports of much better than expected US HRS yields along with overstated USDA 09/10 US wheat demand suggest that WASDE's is understating 6/10 US all wheat stocks forecast by 100 mil bu. Washington's decision to prioritize ethanol over livestock will discourage further investment in US meat/poultry production thus severing an important source of growth for domestic feed/protein consumption. Meanwhile, productivity gains in corn yield continue as the growth in US demand for corn ethanol approaches the 15 bil gallon cap.

Advise selling rallies in grains, bull spreading deferred beans and selling corn calls.

~Rich Feltes

CRB: Look for continuation of range trade from 395-425 as market attempts to balance negative fundamentals on select commodities vs. prospects for improving investment inflow on perceived renewal of economic growth. Commodity bears cite large '09 N. Hemisphere grain crops, end of summer driving season, slowdown in PRC bank lending and seasonal tendency for equities to erode during September. Commodity bulls are encouraged by Washington gridlock, low manufacturing inventories, large bloc of sidelined capital, a bearish late September dollar outlook and low expectations on Q4 '09 earnings. Commodities poised to falter include grains on large '09 North American production, gold on ETF outflows, crude on lackluster demand and cattle on reversal of cattle/hog spreaders. Additionally, the copper chart looks over-bought with culmination of fund short covering. Commodities poised to find support on breaks include soybeans on strong demand, hogs on lower weights/huge August slaughter reducing Sept production and sugar on concern that wet Brazilian weather will persist. CRB penetration of 430 (highs posted in June & August) would portend an upside breakout while penetration of 395 summer lows suggests downside follow-through. Bottom line—look for choppy/range bound CRB trade during September with a downside bias given investor caution ahead of potential CFTC autumn revision of position limits/index hedge exemptions that, once clarified, will remove the unprecedented shadow of regulatory uncertainty.

~Feltes/Kalivas/Pawlicki

Debt Markets: Buy the 5 year and sell the 2 year and 10 year (butterfly spread yield) at -42 bps. Target -20 bps and risk -51 bps.

Buy FVZ9 at 115-13 and risk 114-20. Target 117-17

Equity Markets: Buy SPU at 975. Risk 964 and target 1020.

Currencies: Sell EUR/USD or AUD/USD at market. Risk 1.4446 and .8471 respectively. Target: 1.3833 and .7900 respectively.
Sell DXY 80.890. Risk 82.00. Target. 78.00

Energies: Sell CLX9 at \$74.00, target \$66.00, risk \$76.00
Sell RBV9 at \$1.92, target \$1.60, risk \$2.00
Buy HOV-RBV spread at -5 cents, target +15 cents, risk -10 cents

Precious Metals: Sell GCZ9 at \$975, target \$900, risk \$995

Grains: Sell rallies in Corn and Wheat

Sell corn calls

Bull spread deferred soybeans

CRB: Sell rallies in CRB