Asset Class Roundtable

Overview and Outlook for Financial Commodity Market Volatility
Man Global Research – 6/21/07

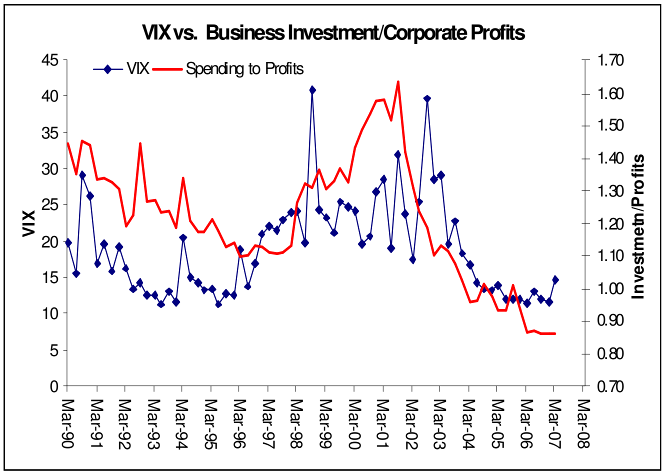
Nick Kalivas- Equities:

Equity volatility, basis the VIX, has established a higher trading range post the equity market correction in late February early March. The VIX is likely to find downside support at 12% and upside resistance at 20% through the early fall and maintain a trading range which is above the level seen during 2005 and 2006. Equity volatility is likely to be driven by the following:

- **Corporations are leveraging their balance sheets**, which should lift volatility. Debt is being swapped for equity making the return to shareholders more variable. Recent examples include:
  - HD's $20+ bln share buyback and the issuance of $12 bln in debt.
  - EXPE has announced a $3.5 bln buyback
  - NSM has announced a $2 bln buyback and issued debt to finance the transaction

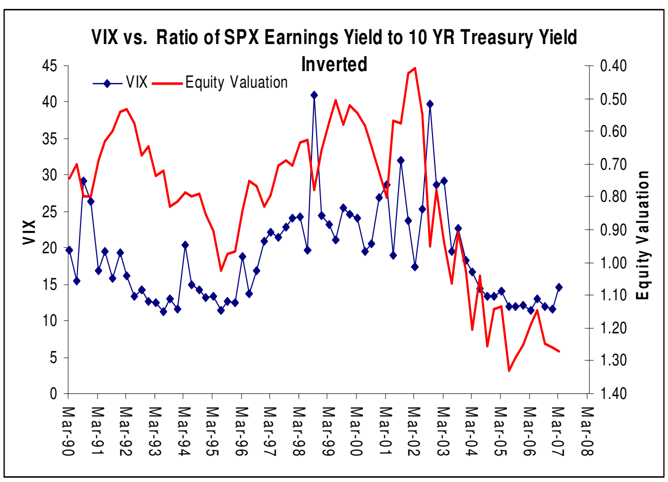
- **The U.S. consumer sector is soft** from a "bottom up" basis as companies like DRI, EAT, SBUX, and SONC have displayed soft sales. Likewise, comparable chain and department store sales have been anemic tracking below levels seen over the past three to four years. BBY is the most recent case and reported U.S. sales up just 1.7% in its reporting quarter. A weaker consumer sector will put profit growth at risk and raise the risk premium in the economy.

- **Volatility will be capped by the strength in international economies**, which are providing diversification to corporate profits and cash flow. U.S. corporations are deriving more and more of their income from overseas. The regional diversification of revenues is reducing economic and profit risk.



- **Corporate spending on plant and equipment is anemic**. Historically, weak investment spending as percent of corporate profits has capped volatility. As companies spend more on plant and equipment, they have less money available to service debt and return to shareholders. Likewise, there is risk that large capital spending plans fail to work out as planned. The trend toward business spending is likely to stay weak. Productivity, sourcing, and technology have limited the need for major expenditures.

- **There is a relationship between equity valuation and the VIX**. Periods of cheap equity valuation tend to coincide with low volatility. Likewise, periods of expensive equity valuation tend to coincide with high volatility. Equity valuation is relatively cheap basis a comparison of the 10 year treasury yield to the earnings yield on the S&P 500.

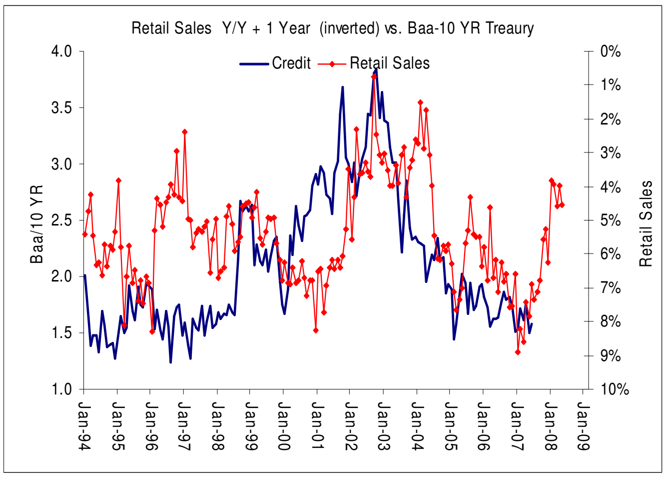


- **The entrance of sovereign monies into the equity market** may cap volatility as the markets will find a slower seller and potential bidder of last result.

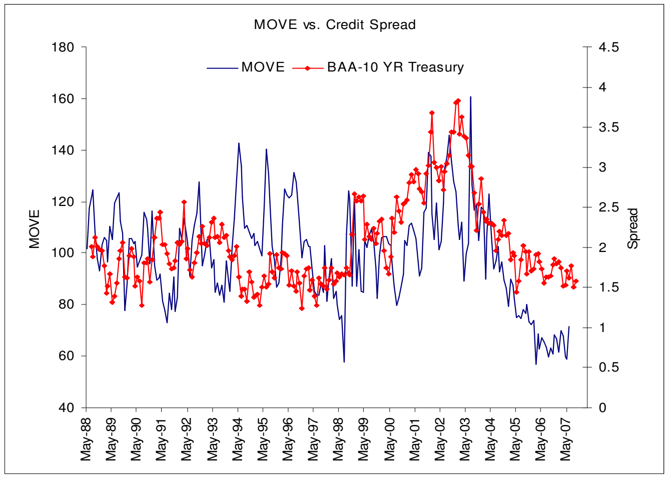
Nick Kalivas- Credit Markets:

Credit market volatility is likely to become elevated due to sub prime and CDO risk. The default rate on high yield debt is also at an extremely low and is likely to trend higher in the coming years as issuance has increased and the economic cycle matures. However, the global savings rate is trending upward due to growth in emerging economies and will help to cap volatility. Large sovereign presence in the market also acts to cap volatility. Additionally, corporate spending is weak and tends to keep volatility low. Factors driving volatility include:

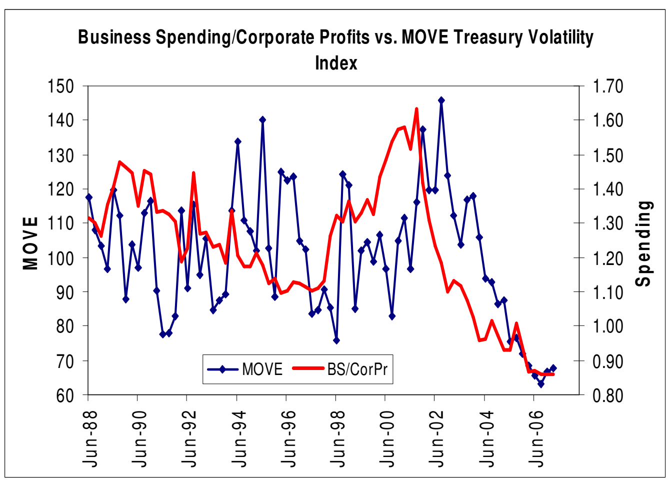
- High yield issuance has been strong in recent years and implies that the default rate, which is currently at a historically low level, will rise in the coming year. A higher default rate will inject uncertainty into the interest rate environment. The process is likely to unfold very slowly. In fact, some may view the current default rate as a reason for low volatility.



- The lower credit buck of the ABX is flirting with all time lows and is likely to lift volatility. Mortgage reset and payment shock issues along with a climbing mortgage delinquency and foreclosure should but a floor under volatility. The housing market creates a headwind to the consumer sector. Historically, weak consumer spending has lifted credit spreads and wider credit spreads should be consistent with higher volatility.



- Weak investment spending tends to hold down volatility. The graphic illustrates the relationship between credit market volatility as defined by the Merrill Lynch MOVE index and the ratio of investment spending to corporate profits. Although corporate spending is likely to remain sluggish, it might be difficult for it to show weakness consistent with the recent trend.



Mike Malpede- Euro Currency volatility:

The graph above shows no increase in volatility in FX markets despite uncertainty about U.S. economy and interest rates.

Main reasons for low volatility in FX trade:

1) **Structural change in financial markets**
   a) Globalization of financial markets has increased liquidity

2) **Growth in risk management tools**
   a) More sophisticated risk management tools
   b) More of them (derivatives)

3) **Growing central bank foreign reserve holdings**
   a) China tops one trillion in foreign reserve holdings

4) **Cyclical factors**
   a) Interest rate convergence

Volatility may increase if:

a) Disorderly unwind of carry trades (watch the vix index)
b) Threat of global recession
c) U.S. attacks Iran
d) China tightens aggressively and global liquidity dries up

Rich Feltes- Grain/Oilseed Markets:

Option Seasonality: Corn option volatility typically advances sharply during the first 3 weeks of June before peaking out on or immediately before the 4th of July. Corn volatility thereafter drops off slightly during July and by a more pronounced degree from early August through Sept (following completing of pollination). Soybean volatility also peaks in early July but erodes more slowly from August through October than corn presumably because of the importance and yield uncertainty associated with late summer pod fill. Wheat option volatility actually peaks in April, erodes through May/June and then rallies again to secondary high in early August before eroding steadily (like corn) during Aug/Sept/Oct. Unlike other commodities, seasonal volatility in Ag markets is fairly predictable given consistency of growing season and its importance to securing adequate supplies for the upcoming marketing year.

Wheat Volatility Update: Wheat volatility, amid excess precip in US HRW belt and too little in the FSU belt, has posted new highs in keeping with seasonal strength. We have no interest in shorting CGO wheat (which may have another 75 cents upside) given hand to mouth end users, strong technical backdrop, shrinking global supplies and intensifying competition with row crops for additional wheat acreage in '08/09 crop cycle. Large wheat tender line up next week viewed as supportive. Advise against corn/wheat until after July crop report even through this spread is out to unusually wide levels. US HRS crop, although experiencing high ratings, is vulnerable to continuation of heavy rainfall. Prospects for continued decline in '08/09 global wheat stocks suggests that late summer/fall erosion in wheat will be less than end users and shorts would prefer.

Corn Volatility Update: The market knows that most critical stage of '07 US corn production will be over within only 5 weeks. Corn option volatility has not trended higher through June despite dryness across eastern US Corn Belt and historic gains in wheat over corn. Failure of open interest to advance during FH June rally suggests that market is skeptical about a shortfall in '07 US corn production given early emergence, above average US crop ratings, low loss potential from early autumn freeze and best sub soil moisture reserves in years. Corn seasonals turn negative following the July crop report. Summer rallies in CZ rarely exceed 50 cents. Suspect that highs are in until early July when absence of threat to '07 crop production could mark beginning of extended 75 cent break. We think near term fundamental story is still better in wheat than corn. Prospects for continuation of strong growth in ethanol demand growth and corresponding need for even more acres in '08 will limit CZ late summer/fall lows to $3.25.

Soybean Volatility Update: Unlike corn, soybean volatility has advanced strongly since mid June on heels of robust US & global off take, the strong rally in global edible oils, resurgence in the Brazilian Real and widespread expectations for multi-year drawdown in US and global protein supplies. Above average start to '07 US growing season provides base for trend or higher yields although traders know that critical portion of soybean production cycle is still 3-4 weeks away. Repeated failure this week to hold value reflects concern over approaching June 29th acreage and stocks report, prospects for break in dry eastern Midwest weather pattern and awareness of strong tendency for SU erosion following July crop report in non mega-stress years. SX unlikely to break significantly below $7.75 for prolonged period late summer/fall in the absence of a bumper ’07 US yield given critical need to stimulate minimum 5% gain in ’08 S. American soybean acreage. Global soybean off take remains brisk despite high prices. Summer rallies in SX typically 80 cents to $1.20 which is clearly within reach given investor community preoccupation with shrinking US and global oilseed stocks. Suspect that summer volatility peak in soybeans will be later than normal (unless weather is ideal) given high index and trend following fund participation in soy complex and generally uncovered status of soy product end users.

Wrap Up: Upside potential on wheat and soybean volatility near term likely greater than corn which because of surge in ’07 US corn area and great start to US growing season has more cushion for additional yield adversity than small grains and oilseeds. All ag markets unlikely to retreat this fall as low as historical stocks vs. price studies suggest given low level of global grain stocks, large fund positions and looming battle for ’08 acreage which will be far more intense than early ’07. Advise getting long SX ’08 vs. shorts in CZ ’08, owning MLS vs. shorts in CGO wheat, buying SH ‘08/selling SX ’08 at 10 cents and selling CZ’07/buying CZ ’08 at 5 cents.

Tom Pawlicki – Energy:

Volatility in energy markets has a seasonal component to it. In crude oil, volatility tends to rise in Dec-Jan and again in Jun-Aug. Heating oil behaves in a similar manner. The timing of the rises seem to coincide with the heating season in Dec-Jan and with the hurricane season in Jun-Aug. In gasoline, the volatility rises in Mar and again in Aug. In Mar, many refineries switch over from attempting to produce more heating oil to attempting to produce more gasoline. Being at the end of the refining cycle, therefore, suggests that refineries are under the most stress just before the beginning of the spring maintenance season. That’s the time of the year when it’s typical to see refineries having problems with restarts, leaks in key units, or even fires. It can be seen in this year better than any other.

The outlook for volatility in energies is to generally hold flat through the end of summer. The NWS forecast released today called for a decreased impact from La Nina and for cooler temps in the Midwest. The lesser degree of La Nina should deflate a bit of the hurricane premium that currently exists in the markets. Cooler temps in the Midwest will cool demand for natural gas fired peaker plants used to provide electricity during those months. Both aspects should keep pressure on energy prices through September.

The potential for volatility lies in the fourth quarter, where market comfort with $60+/bbl oil could evaporate if it became evident that an exit from the oil market began. The high level of inventories at the moment suggests that a sharp decline is possible but unlikely.