

# Asset Class Roundtable

## The Impact of Conflicting Monetary Policy Signals On Financial and Commodity Markets

**MF  
Global  
Research**

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**Introduction by Kevin Hall, Senior Vice President Institutional Services:** Good afternoon Man offices and affiliates. My name is Kevin Hall, and I would like to welcome you to Man Group's Asset Class Round Table Discussion. I am joined today by:

- Jason Mylett, Man research's Base Metals Analyst;
- Nick Kalavas: Man's Senior Capital Markets Analyst,
- Mike Malpede: Senior Foreign Exchange Analyst, and
- Rich Feltes, The Director of Man Global Research and the firm's Chief grains analyst

Today's call relates to recent actions by the World's Central Banks to respond to the dramatic correction experienced across most of the trading markets over the past two weeks. What started as weakness in the sub-prime sector of the residential mortgage market has expanded into a full scale credit event—triggering a profound liquidity squeeze that, many view, has the potential of affecting global economic stability.

Prior to June, when the escalation of sub-prime defaults led to the demise of two Bear Stearns hedge funds, both the Fed & ECB maintained hawkish monetary policies—guarding against, what they described as, high & sustained core inflation.

The recent market dislocation has required that Central banks add significant reserves to the system—measured in 100's of billions of dollars. Against this backdrop, their stated long-term policies remain intact—fostering a continued restrictive monetary policy. This disconnect, supporting both an accommodative short term posture and a hawkish long term policy, has introduced a degree of confusion into the market place.

With that as background, I would like to open the floor to discussion, asking each panelist if these mixed signals from our Central Banks have impacted their respective markets or their longer term price forecasts.

### **Nick Kalivas- Central bank activity is conflicted in the wake of recent credit dislocation:**

On one hand, central bank member rhetoric is hawkish suggesting no official change in policy and expectations for continued economic growth and monetary tightening. On the other hand, the Fed has cut the discount rate and persistently kept the fed funds rate below the 5.25% target. The ECB has been

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extremely generous with liquidity working to stem credit risks created by European bank CDO exposure and a closed asset backed commercial paper market. Implications for the capital markets include:

- **The dislocation in credit is likely to cause the yield curve to find a steeper shape.** Banks are underweight treasuries and may need to build up their treasury holds to offset real estate and other potential credit losses. FDIC data indicated sharp deterioration in the credit picture and warned some banks are becoming under reserved for loss. The yield curve steepened dramatically in the early 1990's after S&L/Banking crisis.
- **Most of the move in the yield curve is likely to come from the short end of the curve.**
- **Real short term yields are relatively high.** Historically, fed funds have averaged 200 bps over the core CPI. This equates to a fed funds rate of 4.25% -- 100 bps below the current target. If the economy deteriorates sharply, real rates will move toward zero. There is plenty of historical precedent.
- Eventually, a more accommodative Fed would cap credit spreads.
- **If the financing rate falls sharply, the spread between the first and second month in debt futures will widen.** Given the current volatility at the short end of the curve, the roll trade in bond and ten year futures could be very active and tradable.
- **Volatility is likely to be elevated – at least through the September 18<sup>th</sup> FOMC meeting.** The market lacks clarity on monetary policy and there is uncertainty as to whether or not the Fed will be successful. The markets should be more tradable given the uncertain environment.
- **Equities should become more attractive if the Fed drops rates.** Financial shares will benefit from a steeper yield curve and high dividends compared to cash. A number of banks are posting dividend yields over 4% and some over 5%.
- **The spread between the front month and second month in the S&P 500 futures should narrow as financing costs decline.** The decline was limited during the 1998 LTCM crisis. However, the spread traded parity during major Fed rate cuts in the early 1990's and early 2000's.
- **The stock bull market will have trouble emerging until the high yield market becomes unfrozen.** Although there remains vast pools of capital for M&A and LBO activity, business cannot be done in the current environment.

### **Mike Malpede- Impact of shift in interest rate outlook on FX markets:**

- 1) Carry trades may not fully return
  - a) Limit USD downside against Asia and emerging markets
- 2) When financial markets settle down USD will give back some of its safe haven and carry unwind gain – this could be a while as a risk aversion remains high

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### The Price of Risk Jumped Again This Week



(Source Dismal Scientist.)

3) Central bank liquidity adds will help EU capital markets and limit safe haven flows out of the Euro – ECB maintains a hawkish bias

4) A September Fed cut would be USD negative despite uncertainty about September rate hikes in Canada Australia , and Europe and Japan because, none of these central banks are expected to match the Fed rate cut

5) Fed policy uncertainty to add volatility- inter meeting cut or cut at September 18 th policy meeting would be most USD negative as it would fuel carry trade demand

**Conclusion:** USD to trade lower based on lower interest rates and slower growth. Scaling back of European and Asian rate hike speculation will limit the USD downside against Europe. Rewind of carry trade will hinge on equity markets and whether Fed policy action can restore confidence in the financial markets and equities. If Fed fails to cut rates or fails to restore confidence in the financial markets, USD could firm supported by safe haven demand and more carry trade unwind.

Fed rate cuts are USD negative unless financial market turmoil and rising volatility spark short term safe haven USD demand. Expect more two-way trade in FX markets and dip volatility as financial markets stabilize. MFGR is long Euro USD.

### **Rich Feltes: -- Impact of Lower Interest Rates on grain Market Pricing & Volatility:**

Generally, anything that stabilizes financial markets and reduces fear of maintaining existing positions is positive for the grain markets—especially in view of the panic financial/commodity market liquidation selling that occurred in August 10-16, 2007.

Lower interest rates overall are typically supportive for commodities as they reduce attractiveness of financial securities as an investment alternative. Additionally, lower interest rates tend to stimulate economic growth thus spawning wealth creation which boosts investor interest and demand for hard commodities. Nonetheless, there are no assurances that last week's Fed ease will heal credit markets

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from prior excesses in mortgage lending. There is a risk that protracted real estate deflation will prompt a slowdown in consumer spending and economic growth. From a sector standpoint, nickel, copper and industrial metals are more vulnerable in a housing driven economic downturn than agricultural markets where food demand is steadily increasing. Additionally, grains and oilseed commodities in the current environment are justified in carrying additional risk premium in view of extremely tight global grain stocks, increasing bio-fuel pull on corn/edible oil stocks and strong growth in meat/protein demand from Asia.

Thus, the agricultural markets are less dependent on a return to financial market stability than the metals and energy markets. The ag markets will revert to supply fundamentals that typically dominate late summer/early autumn grain/oilseed price discovery sooner than the financial/metals markets. Regarding '07/08 US grain/soybean supplies, we view upcoming USDA Sept and Oct crop reports as vitally important. Both price and volatility for corn could surge Sept/Oct if '07 US corn production, like last year, falls well short of expectations. The 40 cent CZ rally since Aug 16 lows, driven in part by extremes of excess rainfall in the northern Midwest and prolonged dryness in the southern Midwest, underscores the corn market's sensitivity to cuts in supply despite prospects for a record '07 harvest.

Seasonally, row crop volatility typically erodes into the fall but we caution against selling volatility until after '07 US corn crop size is clarified following the October 12 crop report. The next 2 crop reports are enormously important from the standpoint of clarifying '07/08 US row crop supplies and in defining how many US acres the corn market can afford to lose in '08. Advise against selling either wheat or wheat volatility until full impact of substantially reduced EU wheat exports is realized. Wheat volatility, following completing of N. Hemisphere growing season, typically erodes S/O/N. Nonetheless, wheat is unlikely to give up much value until market can ascertain 1) how shortfall in EU wheat exports will be allocated to remaining exporters, 2) approximate size of '08 Southern Hemisphere wheat production. Recent improvement in Australian moisture is a modest positive for wheat but more than offset by ongoing dryness in Argentina and shrinkage in '07 Canadian wheat production.

In conclusion, remarkable recovery in row crop markets since last Thursday despite continuation of "stifled tone" to US credit markets underscores that ag markets are anxious to return to their own fundamentals which are characterized by tight stocks globally, heightened uncertainty over size of '07 US row crops, record highs in wheat and permanent linkage of global food supplies to fast growing energy demand. Ample nearby supplies of corn and soybeans will expand further by upcoming harvest which will not only be earlier than normal but, in addition, tax existing storage facilities with record supplies. Diverging views on whether '07 US corn crop size is larger or smaller than USDA's 8/07 forecast of 13.054 bil bu will keep row crop markets from eroding precipitously. Advise against selling wheat or spreading corn/wheat until after Sept crop report at the earliest. An SX move above 50 DMA would signal potential for further gains to \$8.80 as skepticism over '07 US soybean yield intensifies and estimates of gain in '08 Brazilian soybean area are pared back. Bottom line—all ag markets will readily carry more risk premium than suggested by ample near-by stocks. Hedge funds, end users and specs, knowing what wheat has done in the face of tight stocks and strong demand, will be willing buyers of row crops on setbacks amid supportive fundamentals—especially if '07 US row crops shrink from the August to Final crop reports.

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