Asset Class Roundtable
MF Global Research 2008 Outlook – 1/09/08

Dollar Weakness Persists Through Mid-Year;

Equities to Remain Volatile; Treasury Yield Curve to Steepen Aggressively

Energy, Precious Metals, Corn, Oilseed, Softs and Deferred Livestock Markets to Advance in '08

Introduction by moderator Kevin Hall:
I would like to welcome you to the MGR Asset Class Roundtable discussion. I am joined today by:
- Rich Feltes—Rich is Director of MF-Global Research & the firm's chief grains analyst,
- Nick Kalivas: Senior Capital Markets Analyst
- Mike Malpede: Senior Foreign Exchange Analyst
- Tom Pawlicki: The Precious Metals & Energy Analyst
- Jason Mylett: Natural Gas & Livestock Analyst
- Robert Fox: Soft Commodities Analyst

Today's call focuses on the 2008 trading environment.

Many feel that 2007 will prove to be a defining year. Over the past 12 months, there has been a recognizable paradigm shift in almost all drivers of investment return.
- Politics in 2007 has been marked by a changing of the guard in several key economies, including England, France, and Japan. In 2008, we will experience further changes with elections in Russia, the United States, Taiwan and Pakistan
- Global economic growth has migrated from the developed to the emerging world. A recent World Bank report stated that, in 2007, developing countries accounted for more than half the increase in World imports
- Concerning wealth, the advancement of Sovereign Wealth Funds have changed the international investment landscape with national wealth funds now representing over 5% of the World's financial assets,
- Risk Appetite—though benign in the first quarter, has degraded into year end, with the VIX spiking from a low of 9.66% in Feb to 25%; the TED Spread rallying from 25bps to a high of 140 in December, and corporate default rates climbing from a historic low of 0.9% to a now forecasted 4.8% by the end of 2008.

Against this backdrop, many investors and corporate risk managers are unsure how best to position themselves going forward.

Our goal today is to identify trade opportunities in the financial commodity markets.

Capital Markets - Nick Kalivas:

Interest Rates: The 2 yr/10 yr spread is expected to reach 165 bps. Flat price, the 10 year treasury yield should ease toward 3.50% before working higher in the second half of 2008.

- Monetary and fiscal stimulus is likely to offset economic weakness and stress in the financial system. The budget deficit is expected to rise and lead to more supply lifting yields at the long end of the curve. Fed rate cuts will hold down short term interest rates.

- Chance of bankruptcy among financial and housing companies remains high. A few high profile bankruptcies would not be surprising.

- Banks face difficult environment with real estate (commercial and residential) weak, M&A and PE transactions slowing, and commercial business at risk due to the softer economy. Spread between fed funds rate and 2 to 5 year treasury needs to go positive to bolster profitability and repair balance sheets without charge to capital.

- Consumer sector weak and low interest rates are needed to provide the chance for refinance and balance sheet improvement.

- Economic conditions show similarities to 1990 and 2000 periods. The 2/10 curve reached 260+ bps in each period.

- Negative carry on curve trade in the swap market is noted as risk.

- Sustainability of EM strength will be pivotal to the direction of the 10 year yield outright. The surprise for 2008 would be U.S. economic weakness derailing emerging market growth. Note the World Bank projected developing nation growth would cushion weakness stemming from the U.S. economy. The World Bank put global growth at 3.3% in 2008 and 3.6% in 2009 – healthy.

Trade Recommendations:
Basis on the run treasuries buy 2 and sell 10 at about 105 bps. Risk 90 and target 165 bps.

Equities: Equity prices are expected to trade with acute volatility and wide swings. A reduction in the corporate profit outlook will be balanced by the appearance of cheap valuation. The market is likely to trade sideways from current levels into year end, but the aggressiveness of fiscal stimulus and monetary ease present a wild card.

- Companies and market participants will cut the outlook for profit growth. Slowing economic growth, commodity price pressures, and balance sheet repair will dampen the outlook for profit growth. S&P 500 2008 operating profits are expected to rise 15.1%. As reported earnings should contract on a year over year basis in the first half of 2008. Profit growth is likely to improve going into year end.

- Earnings quality will deteriorate. The spread between operating and as reported earnings will widen not unlikely the 2001 to 2002 period – a period of weak equity prices.

- Balance sheets will be de-leveraged and recapitalized. The result will be a reduction in the amount of stock removed from the market. Buyback and M&A activity will be significantly lower than year ago levels. The remove of equity supply from the market will diminish greatly.

- Since 1928, the S&P 500 has finished higher during a Presidential election year 15 of 20 times or 75.7% of the time. The exceptions to a rally were 2000, 1960, 1948, 1940, and 1932. In should be noted that 1932, 1948, 1960 and 2000 were periods of recession. Current environment has recession characteristics.

- During election years, the best performing months for equities are usually August, July, and June – in order. The worst performing months are usually May, April, and September – in order. Returns in January and February are usually sluggish. March tends to see strength.

- Equity valuation is attractive relative to cash and the treasury market. However, stocks are less appealing when compared to corporate debt. Valuation is not expensive when compared to the 1987 or 2000 period, but valuation can be depressed during periods of high inflation as defined by the ISM price index.

- Sovereign funds are expected to enter the market on weakness and provide support. However, the timing of purchases is difficult. Early injections of capital into financially strapped firms have not gone well.

- Small caps to continue to lag large caps due to risk aversion and lingering credit stress.

Trade Recommendations:
Look for the VIX to range between 18.50% and 32.50%. Buy volatility in the 19% to 20% area and sell at 30%. Sell NDH8 2020 to 2030. Risk 2060 and target 1810. Sell Russell 2000 and buy S&P 500 at a ratio of 0.51 with a target 0.475. Risk 0.525 (basis cash)

Foreign Exchange – Mike Malpede:

USD is expected to trade lower in early 2008 and rebound against the Euro mid year. USD will be pressured by Fed rate cuts and concern about risk of U.S. recession. Midyear, USD will benefit from rebound in U.S. economy and lower interest rates in Europe.

Look for AD to outperform as BOE and BOC cut rates and RBA maintains a tightening bias. The Yen will rally supported by unwind of Yen carry trades sparked by high risk aversion and slowing global growth with additional support from competitive currency appreciation in Asia as the Yuan trades higher and Asian governments let their currencies rise to combat domestic inflation.

Euro USD (140-151): Euro USD is expected to make a gradual rally towards 150 in early 2008 .Euro USD is expected to weaken mid year and trade towards 140 as ECB cuts interest and U.S. economy rebounds. ECB will cut rates in reaction to deceleration of EU economy generated by credit crunch fallout, high energy prices slowing U.S. growth and weakening housing markets in Spain and Ireland. Risk to this outlook, EU economy slows more quickly and forces a shift in ECB monetary policy bias.

Yen (100-114): The Yen is expected to rally towards 100 by year end supported by carry trade unwind sparked by credit market fallout, higher risk aversion and competitive currency appreciation in Asia as Yuan extends post revaluation rally. The BOJ and Japanese government is expected to tolerate modest Yen appreciation to combat rising domestic inflation. Japans CPI hit a nine year high in December. Move below 100 would encourage BOJ intervention. Risk to this outlook, focus shifts to Japan's slowing domestic economy and surprise global equity market strength fuels fresh carry trade demand.

Sterling (188-203): MFGR favors selling rallies in sterling with a target of low 190's as BOE is expected to cut rates twice before the end of 2008. Sterling is loosing its high yield support as the BOE is expected to cut interest rates in early 2008.BOE is expected to cut rates in reaction to impact of credit crisis fallout as UK consumer sector weakens, housing prices fall and retail sales are expected to slow. Risk to this outlook, rate cuts discounted and the trade is too short.

AD -USD (8450-9250): The Australian dollar will trade in a volatile range with an upside bias supported by RBA rate hike speculation, strong Australian domestic growth and general commodity market strength. AD will remain the preferred high yield currency based on divergent monetary policy outlook in UK, Canada and Australia – BOE and BOC will cut rates in 2008 and RBA will maintain a tightening bias. Risk to this outlook--global recession.

CD (9700-11000): MFGR looks for CD to trade lower as the Canadian economy is slowing and BOC is expected to cut interest rates in early 2008. CD downside will be limited by higher CRB and Canada's twin budget and trade surplus. Risks to this outlook, CRB continues to surge.

Dollar index – (7400-7950):

Trade Recommendations:

MFGR favors selling sterling Yen, sterling AD, sterling, and the CD, and buying the Yen. Mid year, MFGR will look to sell the Euro.

Precious Metals & Energy Markets - Tom Pawlicki:

Precious Metals:
Gold and silver prices may continue to advance in 2008, but they will have to do so through investment and speculative demand rather than from increased physical buying or solid fundamentals. We think that the current bullish atmosphere will persist to some degree in the next few months and short-term rallies above $900 may be seen. However, it's not a trend that we believe in whole-heartedly, and we see prices ranging from $732 to possibly $950 on the upside.

In the next few months, trade will continue to focus on strong demand that occurred last year and on additional investment inflows this year. 2007 was a great year for physical demand, with gold prices hovering in non-volatile activity below $700/oz for the first eight months of the year. With India consuming around 25% of the world's gold and their peak demand season approaching, tremendous amounts were bought in that country before prices started advancing in Sep. Indian imports are expected to come in above 900 tonnes for the year, which would be a new record. The Sep price advance began with a large hedge unwind by a major Australian gold producer of around 130 tonnes and started prices on a rally from $660 to the current $890. Physical demand began to weaken in India and U.S. physical demand was weak due to poor economic conditions. ETFs and other investment demand became the savior of gold prices at that point. As a reference, ETFs added 58 tonnes to holdings in the first eight months of 2007 and 130 tonnes in the last four months.

Going into 2008, the gold market will have to depend on additional investment demand to keep prices supported, as physical buying and future dehedging are forecast to be weak. Such investment could keep prices volatile and a rally above $900 will likely bring out gold bugs and further momentum buying. In addition to the less than solid fundamental picture, we're also worried about external factors including the potential that the dollar forms a bottom this year and that carry trades unwind. So while it's anything but a sure thing this year, we think a gold rally is possible this year, but upside should be limited and it certainly won't come without risks.

Trades: Sell gold at $950 target $750 and risk $970

Energies:
The crude oil market has the potential to continue its advance in 2008, but we view the upside as very limited. Prices could rally toward $105 over the next couple months, but longer-term, we expect to see crude fall toward $80 sometime this year.

The main source of near-term support will come from speculative flows, as the CFTC commitment of traders data is showing crude oil fund net longs approaching record levels. The backwardation condition in the futures pricing structure will offer support through its disincentive to build inventories. Momentum buying may also force the market higher, just as it did on Jan 2nd when it rallied above the previous high at $99.29.

Longer-term, however, we're concerned about the strength of the market and see a chance that it falls in Q2 & Q3. The supply/demand predictions by the IEA, EIA, and OPEC target surpluses in 2008 between 0-800,000 b/d. The IEA has the prediction for perfect balance, and it is based on its expectations for normal winter temperatures. Major forecasters and evidence so at hand suggest that temps will be warmer-than-normal this winter, and heating demand should therefore be below IEA expectations. Additionally, seasonal builds in crude oil inventories usually take place between Feb & Jun, and this year shouldn't be different.

Trade Recommendations:
Sell crude oil at $105 target $80 and risk $108

Grains/Oilseeds – Rich Feltes:

Anticipate volatile but well supported grain markets in '08 amid backdrop of low global grain stocks, increasing bio-fuel mandates and continued inflow of index capital into ag commodities (on the heels of impressive '07 gains). Price positive underlying factors include depleted PRC grain stocks, no sign as yet that high prices are rationing demand globally, prospects for additional dollar weakness, financial market instability and the compelling need to discover price level that will attract additional land into crop production. Row crop markets must move higher to pull acres away from cotton, pasture, hay and summer fallow. The steadily increasing percentages of US corn/soybean production converted into fuel are forcing primary food commodity markets to compete with energy markets.

Soybeans will be the upside leader--especially if South American or US crops are threatened during '08 crop cycle. The Argentine weather pattern during last 3 weeks is characterized by erratic rainfall and much warmer than normal temperatures. Brazil's weather pattern is more favorable although local crop forecasters are more cautious on '08 Brazilian soybean production than USDA. The market is legitimately concerned that '08 US soybean acreage may not advance sufficiently to preclude tight 9/09 US soybean stocks just as S. American soybean area gains fell short of expectations in late 2007. Soybean prices could surge substantially (into high teens) with either a poor finish to the '08 S. American growing season, lower than expected '08 US soybean area or adverse '08 US growing season weather. Additionally, even large gains in '09 S. American soybean production will not build global stocks in the '09/10 cycle.

March corn, despite recent posting of all time highs for January, has further upside potential into mid $5.00 area. Substantially higher corn prices will restrain corn usage sooner than high wheat and soybean prices restrain usage given the later two's lower elasticity of demand. Specifically, substantially higher corn prices will eventually reduce US ethanol and livestock usage of corn. The corn market would break on a substantial correction in crude oil although MFGR believes that a break below $80/barrel in '08 is unlikely. Additionally, the ethanol boom is predicated on shaky economic underpinnings which could falter if summer drought forces Washington to choose between food and fuel. Furthermore, if a shortfall in '08 Northern Hemisphere grain production forces PRC type food inflation to spread to the US (prompting a temporary suspension of US ethanol mandates as USDA is unlikely to preside over the demise of the US livestock industry) then corn demand would slow and gasoline prices would rise given corn ethanol's 5% contribution to US gasoline usage. Nonetheless, under a trend or higher '08 US corn yield scenario, it will be difficult to build US corn stocks given steadily rising ethanol mandates and no evidence as yet that cellulosics will replace corn as the most viable f

Wheat has the best prospects for a substantial price break but not until spring rains assure a rebound in '08 US/global wheat production. Advise against picking tops in wheat with row crop upside undefined, the tightest US/global wheat stocks situation in history and uncertainty over transition to more plentiful '08/09 supplies. Remember that wheat prices posted new all time highs while corn is within 75 cents of all time highs posted in 1996 despite largest '07/08 global all grain crop in history. View corn/soybean price downside as minimal prior to pivotal '08 US growing season given prospects for decline in 9/09 US stocks at trend yields. We are unable to endorse the Economist Magazine's forecast for a Global Warming induced 16% cut in world grain production by 2020 but will note that a mere repeat of the '07 US corn yield in 2008 would reduce '08 US corn production nearly 500 mil bu thereby thrusting '08/09 US corn production well below usage. Thus the corn market, and to a lesser extent wheat, will be unable to break substantially lower until the '08 US growing season is underway.

Trade Recommendations:
Advise buying deferred soybean contracts on breaks, spreading Dec/Sept wheat in both CGO and KC (looking for modest carries to widen), buying corn and selling wheat (when and if US spring rains normalize in the southern plains) and buying Nov '08 soybeans against shorts in Dec '08 corn. Increased linkage between food and fuel markets portends an extended period of elevated grain/oilseed prices.

Natural Gas & Livestock: – Jason Mylett:

Natural Gas: Erosion of supply surplus, declining imports, and excessive short interest to lift the front of the price curve, pushing the Q1 and Q2 term structure into further backwardation. Deferred prices remain supported by declining domestic well production rates.

- MF Global expects a dramatic shift in the gas supply situation over the coming weeks. Current inventories are forecasted to move to a 10% on-year deficit while the surplus against the historical 5-year average will drop from 8-10% to 3-5% by mid-Q1.
- Increase in taxes on Canadian oil and gas companies will discourage production choking off exports to the US.
- LNG imports, now 15-20% of net imports, show signs of decline while expansion of LNG gasification capacity remains unpopular.
- Futures market structure suggests the speculative net short position is historically over-extended.
- Combination of bullish supply shift and over extension of fund shorts will support prices in the front of the term structure encouraging bull spreads to work as well.
- Natural Gas rig numbers near record highs as well production rates continue to decline.

- Declining well production rates will continue to support the back of the price curve.

Livestock: Producers and feeders to experience continued margin erosion in 2008. Deferred cattle and hog prices will be supported by historically rallying grain prices.

- Increased autumn and winter placement of cattle into feedyards points to increased fed supplies through Q1 and Q2. Cash cattle and futures to see lower prices ahead.

- Pork prices to remain historically subdued through the summer on impact of increased production efficiency as a result of circovirus vaccine.

- Liquidation of Canadian cattle and hog herds encourage record cross-border movement. Canadian producer capitulation to add additional red meat supplies to US balance sheets through Q3.

- Weak USD and increased access to Asian export markets to act as supportive feature for beef and pork in 2008.

- Look for prices to recover by Q4 with US food inflation likely to be featured in the news cycle.

Softs: – Robert Fox:

Cotton: Given the current slow pace of US exports, look for the cotton market to enter a period of consolidation over the next few months. However, we remain optimistic that prices will continue their upward trend later in the year. The long-term S&D looks bullish as 2008/09 US stocks could reach their lowest levels since 1996 due to significantly decreased cotton acreage combined with strong import demand from Asia. Given its modest performance in 2007, cotton will likely remain attractive to funds in 2008. One potential concern would be a global economic downturn slowing the growth of global cotton consumption.

Coffee: Look for coffee futures to continue their trend of gaining 16 percent per year since 2002. Currently, the global stocks-to-use ratio is at its lowest level since USDA started keeping its database in 1960. Right now, the market is focused on the size of this year's Brazilian crop, as Brazil accounts for about 30% of global production. The crop there follows a two-year cycle of high followed by low production levels. Brazil will be in its high cycle in 2008 and global supplies should be adequate. However, the Brazilian crop could be down by 25% in 2009, which would lead to alarmingly low global stock levels. Turning to the demand side of the equation, global consumption has risen a steady 3-4% in recent years led by developing countries like Brazil and Indonesia. That trend is likely to continue.

World Sugar: Because of historically high stock levels, we expect world sugar prices to weaken and perhaps test the 10-cent level in coming months. Sugar was one of the worst performers in 2007 and with good reason. Over the past two years, global supplies have risen by a third mainly due to excessive production in India and Brazil. The recent run-up in prices has been caused by heavy fund buying and hopes that sugar-based ethanol production will come on-line quickly to absorb excess supplies. However, Brazil is currently the only country with the ability to produce sugar-based ethanol in any appreciable amount. While Brazil's ethanol production will expand this year, it will only be enough to account for yet another increase in sugarcane production. In fact, due to low ethanol prices and tightening credit markets, many of Brazil's proposed ethanol projects have recently been scrapped. While ethanol production will eventually drive up sugar prices, that time may be 12-18 months away.

Trade Recommendations:
Look to buy coffee: given the tight fundamentals, any problems with the Brazilian or Vietnamese crop could send prices soaring.

Avoid the sugar market at any price above 1050 due to burdensome supplies.

Avoid March cotton as plentiful supplies could weaken prices in the near term.