



## EMERGINGTRADERS WEEKLY

July 21, 2008

### Systematic Shift

I'm not a doomsayer. I'm one of those that believe in downplaying the apocalyptic frights that come over the market every time there's a shift in sentiment. It's happening more frequently now while growth and inflationary aspects of the economy oppose and have trouble gaining enough common footing for the Fed to help mediate.

Last week panned out to be a mix of different sentiment drivers but left us with an aftertaste of inflation fear. While officials are so keen on keeping the health of our financial institutions in check, their other main concern is preventing further declines in the dollar, which took a battering last week. The solutions to these two related problems are almost contradictory. I don't profess to know more than our trusted leaders but I wonder, if they raise rates to combat inflation and support the dollar, can we expect the printing of more dollars to purchase collateral in the faltering institutions? What will that do to the dollar?

I believe in the theory that sentiment is the driver behind all market moves. Confidence of financial institutions in themselves and the markets is extremely low after suffering lows in the sector not seen in almost 2 decades. The support and backing of Fannie and Freddie is a staging of the government's ability to assure institutions that there will be adequate capital for banks to meet their liquidity needs. The dollar's far from out of the woods but I don't know if raising rates will be the catalyst for a revival in it's strength as it will create more turmoil in the sector we are trying to save.

Treasury Secretary Henry Paulson is scheduled to speak on Tuesday on the condition of the U.S. economy and capital markets. There will likely be an effort to revive some confidence. A Bloomberg story over the weekend stressed his optimism about Congress passing legislation to allow the government to rescue Fannie and Freddie, part of that meaning it can purchase equity in both institutions. He's also put forth a suggestion that banks should start issuing covered bonds without waiting for legislation to pass through Congress (see Bloomberg attached story). It sounds a bit like another one of those band-aids to buy a little more time. I don't see how issuing more debt could help the balance sheets of our financial foundations.

So, what all this means to us as traders is simple. We know that that equity markets are quicker to take negative news seriously than positive. We are seeing small and short-lived rallies come from better-than-expected earnings reports out of the financial sector but they are stifled by either rises in commodities or disappointing economic data. Fixed income markets are quick to factor in inflation fears in recent weeks but flight-to-quality bids are often born out of banking sector weakness rumors. There has been a significant drop in probability that the Fed will stay on hold through year-end. Currently there is an 18.4% probability discounted into futures that rates will still be at 2.00% until the end of '08, a 40.8% chance they will be raised to 2.25%, a 31.1% probability of a 50bp hike, and a 9% probability that Fed Funds will be 75bps higher. Now that we are half-way through the third quarter, it's safer for us to look towards the fourth than a few months ago. I don't want to be the last one to the table to get in on inflation trades but I'm looking to technicals to help pick a direction. I was happy to see 5 and 10 yr yields resume their climb but I'm not seeing any good opportunity to collect premium at the moment in options space. For my trade of the week, I'm looking for our 2-10 yr curve to get down to 138, then I'd get back into a steepener. My reasoning for this is that I don't think the markets are quite ready to break one way or the other and we're safe in our ranges for now.

I've attached a Bloomberg article highlighting Paulson and the GSE situation <http://www.bloomberg.com/apps/news?pid=20601087&sid=a6fBFHXXbSs&refer=home> and one from this weekend's WSJ that gets into the nitty-gritty on subprime <http://online.wsj.com/article/SB121641296022866029-email.html>. I'm not sure why the findings on FDIC-backed MBS securities are not getting more attention this morning.

For the week ahead, barring anymore banking system failure headlines, possible resolutions to the Fannie and Freddie situation as well as housing sector data should be in focus.

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