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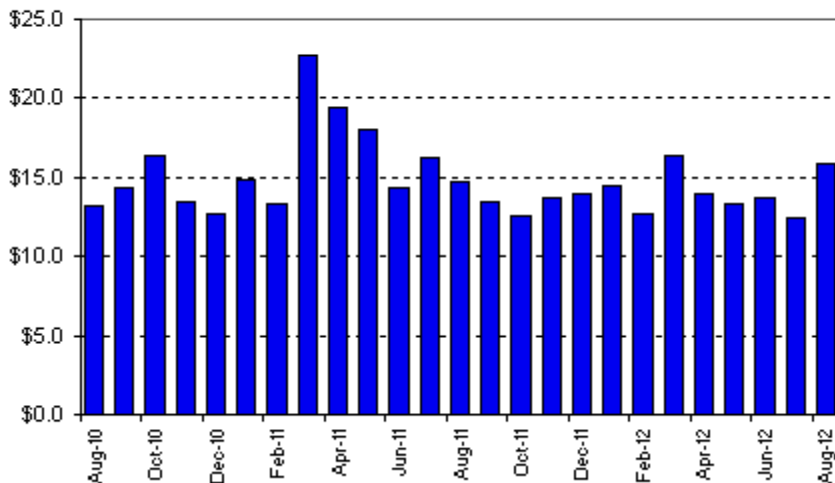
MCAG MACRO: MACRO-REALITY

AUGUST 12TH, 2010

I am biased. I believe if a trader is bred into fixed income he or she has the ability to see forest for the trees. If the trader is bred into the equity world he or she doesn't even know that ability exists. Recent market activity supports my theory.

Yesterday equity markets had a reality check session following Tuesday's release of the latest FOMC statement. In recent trade leading up to the release, risk assets had a sort of fantastic run in combination with the anticipation and other contributing factors like strong earnings reports. Tuesday's Fed decision was to maintain its holdings in the System Open Market Account near \$2.054 Trillion by buying longer-dated treasuries (specifically, by rolling over the agency debt and agency mortgaged backed securities). Just how much money is this? Courtesy of Stone and McCarthy Research: *Most of the Fed's re-investable cash will come from principal payments associated with its MBS holdings, which total over \$1.1 trillion. There is a lot of uncertainty associated with principal payments on MBS because of prepayments due to refinancing. Most estimates for MBS principal payments to the Fed are in a range of \$10 to \$15 billion per month.*

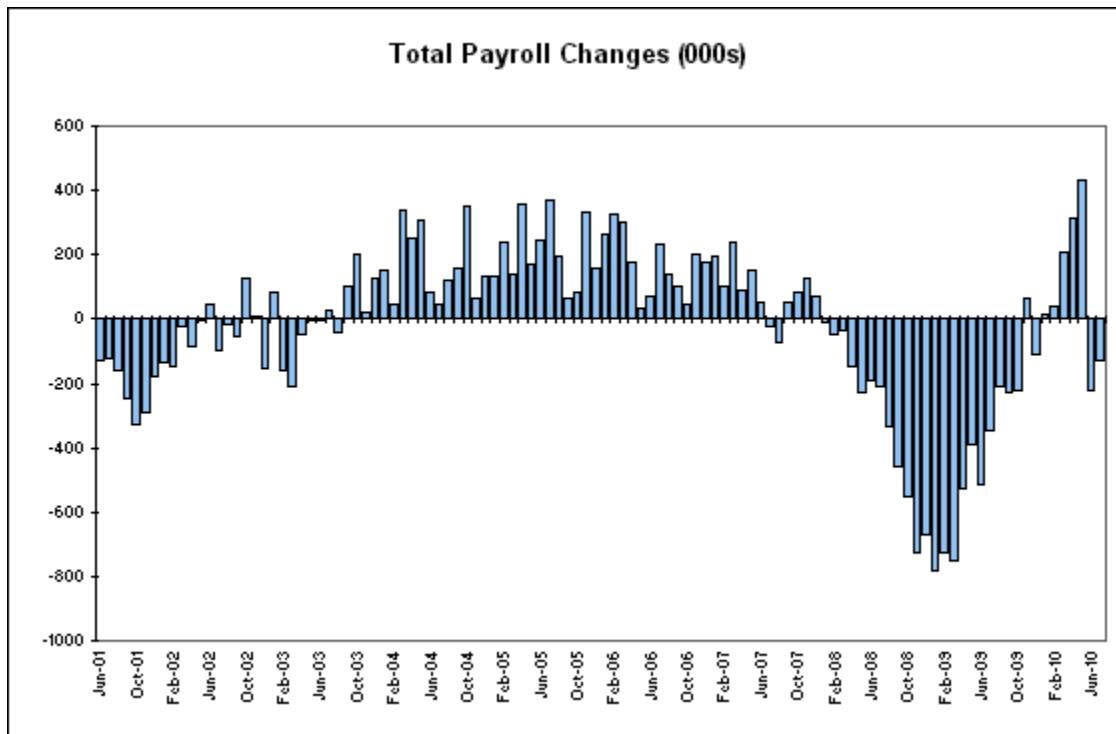
Fed's Maturing Agency Coupon and MBS Holdings
(In billions)



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The disconnect present between equities and fixed income before Tuesday's release proved bonds to be right. Although the disconnect can be common in the early stages of recovery due to equities rising while inflation subsides and monetary policy continues to ease but we know it's different this time for a few reasons. Among other things, the timing is off and policy action has been unconventional, so the disconnect something to pay attention to. Although I would've liked equities to be right because it would have made the simple steepener put on after the Humphrey Hawkins testimony work better in the short-run (maybe I shouldn't remind you but I have to put it out there that I don't profess to be right all the time), I also have to point out the false optimism that was present in equities. In this case the risk rally perpetuated not only as a result of positively surprising earnings reports but because of the speculation that the Fed would release more artillery in the form of quantitative easing to prevent further pull-back in recovery. Although the fact that the Fed stands ready to do whatever it takes to boost economic recovery can be read as a positive, there's no question that the fact that it needs to do so is blatantly disappointing. Let's be honest.

So ahead of the release, equities and treasuries both factored in more Fed action in their own ways. Equities rallied in the face of a disappointing jobs report (-131K vs. -65K forecast) because of the false reassurance that the Fed would do whatever it takes to inspire recovery. Yields, on the other hand, reflected the fresh economic disappointment by recognizing that the need for further Fed action represents weakness. Now, I'm not suggesting that Treasuries didn't over-do the discount somewhat in the other direction with the 5 year yield dropping 1.2% and the 10 year yield dropping 1.14%, reflecting the belief that abnormally low short rates will persist for many years to come but I am pointing out that the response in the aftermath was the realization that there was no more room left in equity prices to celebrate.



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Risks of a downturn have increased enough for the Fed to delay its exit from unprecedented stimulus already in place. Not too long ago the fear was placed in anticipation of the way the market would absorb the unwinding of existing quantitative easing. That fear will arise again with even more weight as part of the method of unwind, the expiry of assets on the SOMA balance sheet, has been removed and extended. The good news is now equities can join fixed income in relying on macro-economic data and actual economic conditions to drive price action rather than acting emotionally, at least until the next fundamental picture forms.

Looking forward in our managed futures fund space we are not looking to abandon the theory that it is prudent to keep an eye on the balance between inflation and deflation expectations. The near-term picture clearly shows inflation to be a more desirable scenario than deflation as we have more experience in managing it. However, current situation included, no sooner does the market get answers than they are wrong, leaving no time at all to rest on our laurels. That lends me to stress the importance of the ability to be nimble. Bonds, equities, and commodities all take a price trend cue based on the inflation/deflation aura. Right now the bias is toward discounting how much and when the Fed will take further QE action. However, with a string of better than expected numbers talk of inflation will resume and the markets will start to factor in an over-done scenario. Luckily for me, the kind of trading we do only needs a bias toward style rather than a trending direction to be opportunistic. Still, my finger has moved closer to the trigger.

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