



Market Weekly

Commodities, Forex, Futures and Options

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HEADLINE OF THE WEEK: “Dollar Heads for Monthly Gain Against Yen on Fed Rate Outlook” (Bloomberg, 5/30/2008)

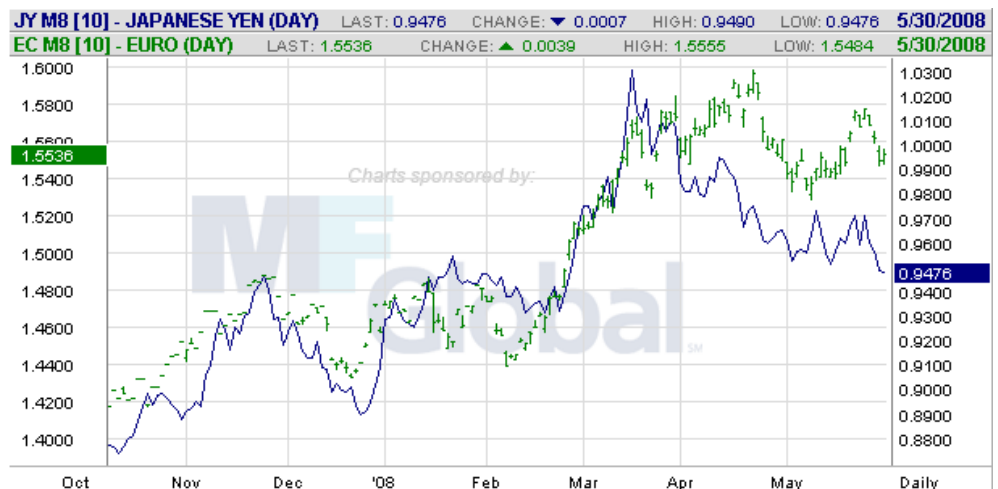
Compiled by Mack Frankfurter, Chief Investment Strategist

Since its peak in 2002, the dollar index, an indicator of the value of the US dollar against a basket of major currencies, has fallen by 40%. Its decline has been particularly large against the euro. The dollar has dropped in that period by about 80% against the euro, and 22% against the yen. Why has the dollar been falling? Among several factors, the huge U.S. budget and current account deficits have been identified as a major reason. The U.S. for several years has run a current account deficit of about 6% of gross domestic product. The twin deficits, which essentially reflect increasing U.S. borrowing from abroad, imply that the currency is likely to weaken. Another factor is low U.S. interest rates. Since the start of the housing crisis, the Fed has responded by aggressively cutting its key rate, which now stands at 2%, compared to 4% in the euro zone and 5% in the U.K. This rate differential means that it is less attractive for foreign investors to buy U.S. fixed income. As a result, smaller money inflows are going into the U.S., causing the dollar to weaken further. So far the weak dollar also seems to have benefits as well as costs. It has improved U.S. competitiveness, partly mitigating the pressure on its current account deficit. However, it would be naive to say that the falling dollar can never hurt the U.S. In the long run, a currency reflects economic fundamentals, and the fall of the dollar may weaken America's status as the global leader.

WEEKLY RECAP

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“...a currency reflects economic fundamentals, and the fall of the dollar may weaken America's status.”



The euro and Japanese yen are starting to show signs of a possible turning point in dollar strength.

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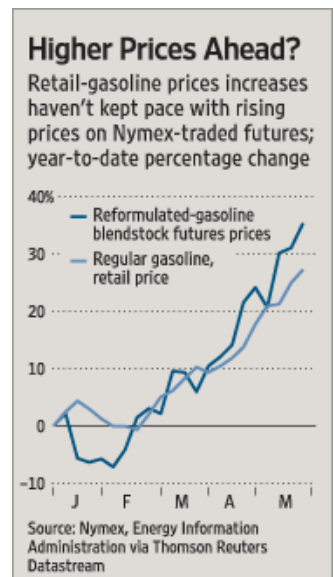
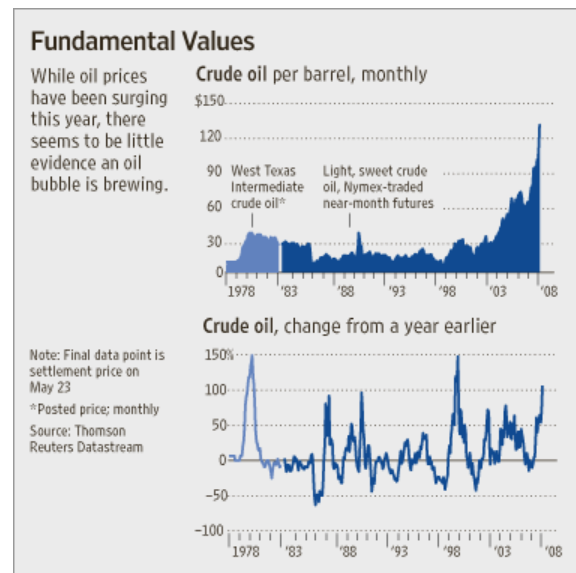
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Headlines from page 1

Morgan Stanley has raised concerns about the dong, Vietnam's currency, saying that Vietnam is heading for a "currency crisis" similar to that of Thailand's baht in 1997. Vietnam's government said this week the inflation rate in May was 25.2% on an annual basis, up from 21.4% in April and 14.1% in January. A slow government response was in large part to blame. When oil and food prices began to rise late last year, the State Bank of Vietnam, hoping to sustain growth, was slow to rein in inflationary pressure by raising rates or clamping down effectively on irresponsible lending. Loosening of the currency's dollar peg backfired largely because of lending practices. Twelve-month non-deliverable forwards show traders are betting the currency will drop 39 percent against the dollar in the next year. Vietnam's current-account deficit, foreign-exchange reserves and inflation are at levels "misaligned" with the dong, wrote Stewart Newnham, a Hong Kong-based analyst at Morgan Stanley. "There is a run on the dong," wrote Newnham. "Many of the classic fundamental conditions are in place including an overvalued currency, a dangerously unbalanced economy and low foreign-exchange reserves. A devaluation episode could trigger a contagion throughout the region."

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The debate raging about fundamentals versus bubble theories has degenerated into Congress getting involved.

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Meanwhile, the saga of the oil debate continues with the Commodity Futures Trading Commission disclosing that there has been a six month broad nationwide probe into potential oil-market manipulation. The CFTC's announcement about its oil investigation suggested a single, broad probe that began in December 2007. But people familiar with its enforcement priorities say the agency is pursuing multiple oil investigations, and that many of them relate to one another. CFTC enforcement chief Gregory Mocek said the agency has about 60 manipulation investigations open in various commodity markets. At the same time, the CFTC has been arguing that raising crude oil margin requirements as some Democrats in the Congress have suggested would set a dangerous precedent and "be dangerous and may send a lot of this business offshore or to unregulated markets..." according to CFTC Acting Chairman Walt Lukken. Managed Account Research agrees, but for different reasons—to read about our analysis, ask MARI to send a copy of our CTA Confidential piece, "The Law of Unintended Consequences."

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ECONOMIC REVIEW

Eurozone inflation has surged back to the record levels seen earlier this year, German data suggested, as soaring oil prices all but ruled out any early cut in European Central Bank interest rate. Germany's annual inflation rate leapt from 2.6 percent in April to 3 percent this month on a European harmonized basis, the country's statistical office reported. Meanwhile, U.S. government bonds came under fresh attack as investors remained gripped by inflation fears. Late on Wednesday, Richard Fisher, president of the Dallas Federal Reserve hinted that U.S. interest rates might need to be raised to curb inflation.

The former Fed chairman, Alan Greenspan, urged central banks to be wary of trying to deal aggressively with future price bubbles, as that approach may suppress innovation and growth. Rather than try to suppress bubbles, policymakers should ensure that financial institutions were well enough capitalized to withstand the hit from bursting bubbles as well as

other shocks. Mr. Greenspan backs efforts to develop countercyclical capital rules that would force banks to hold more capital in good times than bad. Such rules might make it less likely that asset price and credit booms would feed each other, as they did during the housing upturn.

This past week's rise in oil means the dollar price of crude stands about 15 percent above its 1979 peak even after adjusting for inflation. The unremitting increase is placing entire sectors, such as airlines and carmakers, under severe strain, while economists and central bankers fear that it will simultaneously slow economic expansion and raise inflation. At the same time, many business sectors that are not significant oil users are suffering anyway, because of the impact of crude prices on energy costs. For example, utilities hit by energy costs are coming under political pressure in many countries to delay prices rises, which would normally be passed on.

Next Week's Economic Calendar

Last week, first quarter inflation-adjusted GDP growth was revised to 0.9%, from the 0.6% initially reported.

Date	Time (ET)	Statistic	For Period	Briefing Forecast	Market Expects	Prior
2-Jun	10:00 AM	Construction Spending	Apr	-0.8%	-0.6%	-1.1%
2-Jun	10:00 AM	ISM Index	May	49	48	48.6
3-Jun	12:00 AM	Auto Sales	May	NA	NA	4.9M
3-Jun	12:00 AM	Truck Sales	May	NA	NA	5.6M
3-Jun	10:00 AM	Factory Orders	Apr	-0.5%	0.1%	1.4%
4-Jun	8:15 AM	ADP Employment	May	-	-30K	10K
4-Jun	8:30 AM	Productivity-Rev.	Q1	2.5%	2.5%	2.2%
4-Jun	10:00 AM	ISM Services	May	52	51	52
4-Jun	10:30 AM	Crude Inventories	31-May	NA	NA	-8883K
5-Jun	8:30 AM	Initial Claims	31-May	370K	NA	372K
6-Jun	8:30 AM	Average Workweek	May	33.8	33.7	33.7
6-Jun	8:30 AM	Hourly Earnings	May	0.3%	0.2%	0.1%
6-Jun	8:30 AM	Nonfarm Payrolls	May	-50K	-52K	-20K
6-Jun	8:30 AM	Unemployment Rate	May	5.1%	5.1%	5.0%
6-Jun	10:00 AM	Wholesale Inventories	Apr	NA	0.5%	-0.1%
6-Jun	3:00 PM	Consumer Credit	Apr	NA	\$7.7B	\$15.3B

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MANAGED FUTURES NEWS

Chicago took the top spot in a survey of the best cities for traders for the second year running, with London in second and New York in third place. The survey, conducted by *Trader Monthly* magazine, which is aimed at professional traders and hedge fund managers, ranked 50 cities to find the ultimate place to live and trade. The survey took into account work and lifestyle factors, from trading infrastructure, taxes and time zone, to weather and nightlife.

The CFTC has announced a number of initiatives to increase transparency of the energy futures markets, including steps to make sure that the markets are free of manipulation or abuse. The measures will expand the amount and quality of information received from energy traders to further the integrity and oversight of our nation's futures markets, the CFTC said. The recent dramatic increases in the price of crude oil traded on futures exchanges make these efforts paramount. The implementation of these measures will improve oversight of the energy futures markets to ensure they reflect fundamental economic forces of supply and demand, free of manipulation and fraud.

The CFTC today announced that it has reached an agreement with the United Kingdom Financial Services Authority (FSA) and ICE Futures Europe for expanded information-sharing for surveillance of energy commodity contracts with U.S. delivery points, including the West Texas Intermediate (WTI) crude oil futures contracts that trade on both the New York Mercantile Exchange (NYMEX) and ICE Futures Europe in London. While the ICE Futures Europe WTI contract is a cash-settled contract that does not require physical delivery of oil in the U.S., its price is linked to the settlement price of the NYMEX crude oil contract.

Tighter U.S. commodities regulations could hurt American derivatives exchanges as market participants would likely head for budding rivals on foreign shores, analysts said. Two Dubai energy markets are about to launch futures listings that will compete against flagship energy contracts traded in New York and London. The Dubai Gold & Commodities Exchange just launched cash-settled contracts on the world's two crude oil benchmarks, West Texas Intermediate Light Sweet Crude, the flagship contract of the New York Mercantile Exchange, and Brent Crude Oil.

Hong Kong's independent commission against corruption said it arrested 29 people in a bribery probe related to fraudulent derivative-warrant trading that may have generated more than \$100 million Hong Kong dollars, about \$13 million (Canadian) in profits. Those arrested were four traders, six securities brokers, a director of an investment company and 18 of his associates. The ICAC said it seized more than HK\$2 million of suspected bribe money.

One by one, countries across Asia and the Middle East are being forced to abandon price controls on fuel and energy, bringing hundreds of millions of consumers face to face with the true market cost of oil. The effect has already begun to chip away at world demand and may ultimately trigger a slide in crude prices. The fast-changing politics of the emerging world has started to chill enthusiasm in New York and London for oil futures contracts. West Texas Intermediate has so far slipped \$5 a barrel from its all-time high of \$135 last week as hedge funds lock in profits, although analysts warn that it is too early to tell whether the 30pc spike in oil prices since March has burned itself out.

With criticism mounting that pension funds are culprits in the run-up in gas and food prices, the pension industry is starting to mobilize to protect its ability to invest in commodities markets. Pension funds in the last several years have poured billions into commodities-futures indexes. But in recent days, critics from farmers to politicians have questioned whether trading by pensions and other institutional investors should be restricted.

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