



Market Weekly

Commodities, Forex, Futures and Options

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HEADLINE OF THE WEEK: "A passing storm? Is the worst over?" (Financial Times, 4/29/2008)

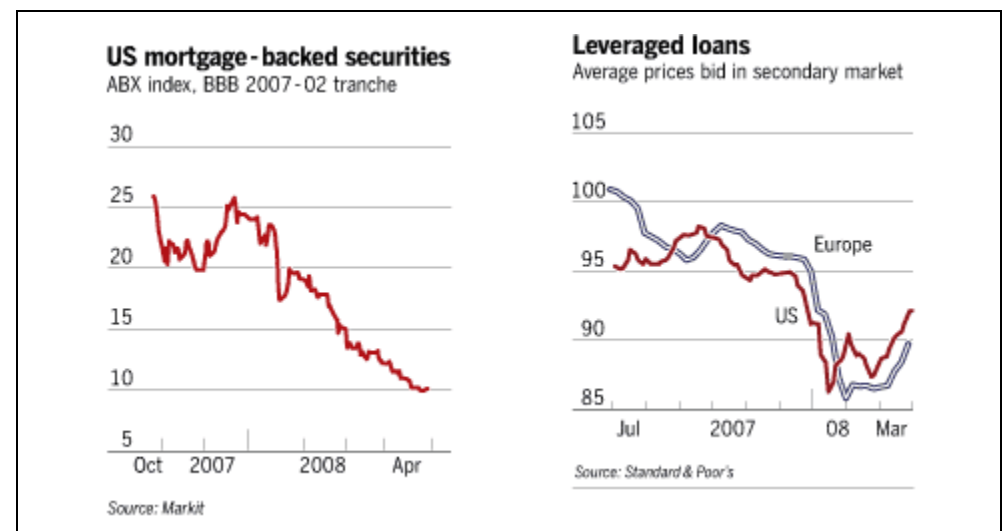
Compiled by Mack Frankfurter, Chief Investment Strategist

WEEKLY RECAP

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A belief is growing on Wall Street that the turmoil in credit markets that began last year could finally be abating. This improved sentiment can be seen in many corners of the credit world as banks, who had "outsourced" their assets and liabilities to special investment vehicles (SIVs) and hedge funds, are now bringing these assets back onto their books, but not the liabilities. Banks are then swapping assets for Treasuries against which they can borrow and plug the funding gap (the Fed just announced it is willing to accept bonds backed by auto loans and credit cards). This in turn has allowed banks to concluded deals which clear backlogs of unsold assets. As a result, Wall Street chiefs are announcing that for them at least, the worst is over, and the switch in sentiment is pulling more investors back into the markets—both stocks and bonds. Yet the markets are still plagued by some startling price anomalies which reveal a continued sense of dislocation and fear. The elephant in the room is inflation, as many central banks have been forced to take their eyes off the inflationary front. Banks are also finding it hard to re-launch their securitization business, whereby loans are repackaged into bonds. Europe is fearful that U.S. fever could be contagious; however Asia as yet remains largely unaffected.

"...Banks are then swapping assets for Treasuries against which they can borrow and plug the funding gap."



It now costs banks more to raise funds than many of their clients, making a return to normalcy difficult for financials.

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Headlines from page 1

In commodity news, money invested in funds which track the two most popular commodity indexes, the S&P GSCI and the Dow Jones-AIG Commodity Index, increased 48 percent since the start of the year, providing tangible evidence that investors may have had a material influence on record energy, food and metal prices. Investments following these indices rose from \$169 billion to \$250 billion, according to Sanford C. Bernstein & Co. “The role that financial fund flows play in setting the price of commodities remains a hotly debated topic... for a number of commodities, there is a strong near-term correlation between growing open interest and rising prices.” As a result, commodity prices “are increasingly decoupled from formerly predictive inventory, spare capacity and marginal cost relationships.” Other analysts disagree, according to Barclays Capital, the rally in commodities is caused by supply shortages and rising demand, not speculation by investors, and that the argument of a “speculative bubble” fails to explain why rare metals, such as cobalt that aren’t traded on futures exchanges, have risen as much, or in some case more, than those that are. We note, however, that it is possible for sophisticated investors to speculate in these markets vis-à-vis OTC derivatives tied to underlying inventories. That said, Barclays makes a good point, “If everyone keeps saying that there’s a speculative bubble, then nothing will be done about rising food prices, and that’s a real global emergency.” This is true if the problem is purely a fundamental supply-demand issue. However, if the problem is systemic as it relates to the booming but opaque OTC derivatives market for commodities, then regulatory loopholes need to be closed to ensure that commodity prices do reflect fundamentals. We think the issues are related.

“...for a number of commodities, there is a strong near-term correlation between growing open interest and rising prices.”



“If everyone keeps saying that there’s a speculative bubble, then nothing will be done about rising food prices...”



The natural resources sector has long made assumptions that price rises are temporary, resulting in low stocks.



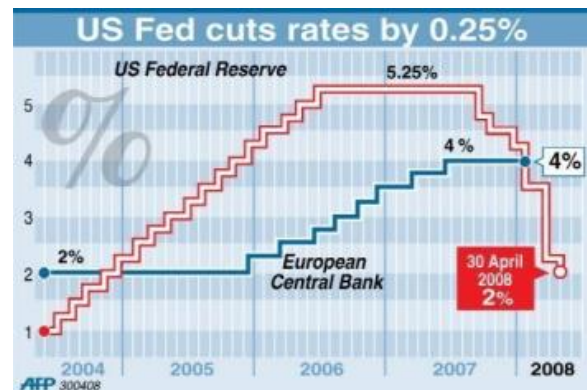
ECONOMIC REVIEW

The Federal Reserve cut interest rates by a quarter percentage point to 2 percent this week and signaled that it might pause. The suggestion of a pause came vis-à-vis typical cryptic interpretations. The Fed dropped its explicit focus on the “downside risks” to growth as well as a pledge to act “in a timely manner,” and highlighted the “substantial easing” of monetary policy that has already taken place. But the overall tone of the statement was more dovish than many expected, and the language contained a gloomy assessment of economic conditions and an implicit bias towards growth risks. The Fed noted that economic activity “remains weak,” business spending as well as household spending was now “subdued” and labor markets had “softened further” with “tight credit conditions and the deepening housing contraction likely to weigh on economic growth.” This language disappointed those who had expected the Fed to toughen its language on inflation.

Meanwhile in Europe, the Bank of England had struck a much more upbeat tone as it appeared to signal the end of the credit crisis, saying that prices in credit markets such as U.S. subprime-related securities, “overstate the losses that will ultimately be felt by the financial system.” All the same, Europe’s economy looks to slow this year and next as the U.S. downturn and the turmoil in world financial markets conspire to keep the outlook bleak. In its latest biannual forecasts, the European Commission said economic growth in the 27-nation European Union would slow to 1.8% in 2009 from 2% this year. “The financial

turmoil is proving deeper, wider and longer-lasting, while the downturn in the U.S. looks set to be more pronounced and protracted than assumed in the autumn forecast,” the Commission said.

In Japan, consumer prices excluding energy and fresh food rose for the first time since in a sign that Japan could be close to shaking off 10 years of deflation. Hiroko Ota, the economy minister, characterized the rise as the wrong kind of inflation. “The price rises are being led by upward pressure from higher raw material costs and not by strong demand, so it is not a good pattern.” As a result, Japanese bonds suffered their biggest one-day rout in five years, instigating a wider sell-off in global bond markets. The rise in Japanese bond yields mirror similar moves across the U.S., U.K. and Eurozone bond markets as investor confidence that the worst of the credit crunch was passing. This in turn sparked a retreat from safe assets.



Next Week’s Economic Calendar

The crude inventory numbers have been a major focus each week, while consumers feel the pain at the gas pump.

Date	Time (ET)	Statistic	For Period	Briefing Forecast	Market Expects	Prior
5-May	10:00 AM	ISM Services	Apr	50	49.5	49.6
7-May	8:30 AM	Productivity-Prel	Q1	1.4%	1.2%	1.9%
7-May	10:00 AM	Pending Home Sales	Mar	-	-0.6%	-1.9%
7-May	10:30 AM	Crude Inventories	3-May	NA	NA	3848K
7-May	3:00 PM	Consumer Credit	Mar	\$6.0B	\$6.3B	\$5.2B
8-May	8:30 AM	Initial Claims	3-May	370K	NA	380K
8-May	10:00 AM	Wholesale Inventories	Mar	0.4%	0.4%	1.1%
9-May	8:30 AM	Trade Balance	Mar	-\$58.0B	-\$61.3B	-\$62.3B

Data is provided for informational purposes only, and is not intended for trading purposes.



MANAGED FUTURES NEWS

A panel of experts at the Futures Industry Association's annual conference in Boca Raton, Fla. concluded in March that clearing is where the action will be this year, and that is certainly true in Europe where after two decades of a slow drift towards centralized, consolidated clearing and settlement of futures and equities, a dramatic shift toward proliferation, competition, and vertical integration has taken place.

The U.S. Treasury Department made some waves on March 31 with the release of its "Blueprint for a Stronger Regulatory Structure," and the tsunami for the futures and options industry was its recommendation to merge the Commodity Futures Trading Commission (CFTC) and Securities and Exchange Commission (SEC). While several industry players applauded the Treasury's study, those plaudits were usually a prelude to saying what is wrong with it.

Now that the CME Group and Nymex officials have a definitive merger agreement, the CME Group removed two impediments to the deal by selling the CBOT metals complex to NYSE Euronext for an undisclosed sum on March 14.

The New York Mercantile Exchange (Nymex) introduced eight new cash-settled electricity futures contracts for the Texas market. Also, Nymex introduced 15 new financially-settled swap futures contracts including an EIA on-highway diesel swap, various gasoil swaps, two heating oil swaps, two fuel oil swaps and a Gulf Coast diesel vs. jet fuel swap futures contract, and launched a New York Harbor ethanol futures contract.

Chicagoans jokingly refer to their hometown as America's second city, but that sort of self deprecation is probably more the norm outside the exchange space. For 160 years Chicago has been the center of futures and derivatives trading, but with the consolidation of Chicago's two futures giants into the CME Group, accounting for 85% of U.S. futures volume in 2007, CME Group is now a global player capable of competing in the over-the-counter space on a global basis.

CME Group launched futures and options on futures on the U.S. Bureau of Labor Statistics' nonfarm payroll data. Also, CME Group's options on futures contracts for corn, wheat, soybeans, soybean meal, soybean oil, rough rice and oats are now available for electronic trading on CME Globex.

The Minneapolis Grain Exchange (MGEX) began trading hard red spring wheat options electronically during the day. MGEX also announced plans for side-by-side options trading. Intercontinental Exchange and Natural Gas Exchange now offer clearing and settlement services for physical OTC natural gas contracts at the Henry Hub delivery point.

A three-part article by Mack Frankfurter, chief investment strategist, titled "The Mysterious Case of the Commodity Conundrum, Securitization of Commodities and Systemic Concerns," received a positive review by DTNAg.com, a website dedicated to the agricultural community. "I applaud Mr. Frankfurter for his wonderful insights and recommendations of ways to improve the efficiency and transparency of futures markets... I encourage all DTN readers interested in a money manager's take on the concerns about the markets to take a few minutes and read his blog. He's spot on." Ron Insana, senior analyst for CNBC, commented, "I greatly enjoyed the white paper and couldn't agree more. I think it's an extremely well-articulated point of view and extremely important... Not to mention timely." For a copy of the article, contact Managed Account Research at (800)308-1495 or by email at: research@ma-research.com.

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