Global Macro Portfolio Partner Letter

Portfolio Background by Seth Zhai

The QFS Global Macro Portfolio focuses primarily on profiting through analyzing and forecasting macroeconomic trends and events. Examples include interest rate trends, political uncertainties, government policies, geopolitical disputes, global imbalances, trade relations, and other macroeconomic stories. Since inception in September 2011, the global macro portfolio has returned 1.05%. Three stories dominated the markets since September 2011.

Europe
The sovereign debt crisis in Europe continues to dominate global markets. Countries such as Greece, Portugal, Italy, and Spain continue to struggle raising additional debt to pay for the many public sector services the governments have provided. On the other hand, the debt-ridden countries have struggled with austerity measures to cutback government spending and increase tax revenues, which have led to protests and riots in the respective countries. Furthermore, the countries risk entering into recessions from the economic slowdown; thus, increasing the difficulty facing the countries. The rising yields on the bonds of the PIIGS reflect the risks involved with investing in the debt of these countries. This rising cost of debt has led to pressure for the wealthier nations of the EU such as Germany, France, and the northern countries to “bailout” the struggling countries by providing loans and mechanisms to purchase the debt. Numerous options have emerged such as the European Financial Stability Facility, European Financial Stabilisation Mechanism, and actions by the European Central Bank.

Resurgence of the United States Economy
Following a slowdown during the summer months, the United States economy has rebounded in the fourth quarter. Economic data points such as ISM, Industrial Production, Business Outlook Surveys, and PMI number have surprised to the upside. Personal consumption by consumers has continued to drive the economy. The manufacturing sector has rebounded and exports have increased as well. Two concerns remain: unemployment and decreasing housing prices. The unemployment rate continues to hover around 8.6% with insufficient job creation. After the slowdown during the summer, non-farm payrolls have picked up to around 100K per month; however, this rate remains inadequate in seriously lowering the unemployment rate. On the other hand, housing prices continue to decrease. The Case-Shiller Home Price Index has decreased around 3.4% YoY with a downward trend. On a more positive note, existing home sales and new home sales have increased YoY and continue to trend upwards.

Weakness in China
Recently, China has faced a significant slowdown with decreases in real estate prices, weakness in the manufacturing sector, and lack of consumer consumption. A slowdown in the world’s second largest economy is detrimental to all regions of the world. Housing prices in China have declined since September 2011, while prices in tier-one cities have declined for longer periods. Prices in Shanghai have decreased by 40% since the peak in mid-2009. On the other hand, Chinese manufacturing has contracted in November and December to end the year. This reflects the weakening demand from abroad such as the Euro-zone. As prices have stabilized, the policy-makers in Beijing will most likely be more aggressive on monetary policy and fiscal policy to help stimulate the economy.

Below, we will discuss some of the trades we executed in 2011.
Commodities Trades

Trade: Long January Heating Oil (HOF2)/Short January RBOB Gasoline (RBF2) by Gabriel Wong
Time Horizon: beginning of October – mid December
PnL: $1,911

Background on Oil/Products: Crude oil (two main kinds, West Texas Intermediate [WTI] and Brent) is refined into gas and heating oil at about a 2:1 ratio, so gas/transportation demand is the main catalyst for crude oil, which peaks during summer travel times. There is also a winter increase in demand for heating oil (mostly in the Northeast), though since heating oil is classified as a distillate along with diesel (which is primarily used for transportation in Europe), its price is also affected by transportation demand. Ultimately, crude oil, gas and heating oil are all highly correlated, with minor differences coming from the use of heating oil for heating and other fuel needs.

Thesis/Catalysts: Given the cyclical tendency for heating oil demand to go up in the winter, and gas/transportation to go down in the winter, it seems logical to go long heating oil/short gas after the end of summer when gas is at its peak, and hold onto the position through winter (thus the January contract should be used). For short-term catalysts, weather forecasts for this year seem to indicate a more extreme winter and heavy snowfall, which should drive up heating oil prices more than expected. This should cause the heating oil/gas spread to diverge in our favor.

Result: The trade immediately became profitable, as weekly petroleum reports showed increasing gas stocks and decreasing heating oil stocks. This demand for heating oil kept rising as the weather was very cold in late October/early November, and the trade was up around $8,000. However, one week there was a reversal in this trend, and the market reaction to this caused the trade to lose most of its profit. Now that the fundamentals of the trade had changed, and upcoming weather forecasts indicated a warmer-than-normal December, the trade was closed off to capture the small remaining profit.

Trade: Long Corn Butterfly Calendar Spread (Dec-Mar-Jul) by Gabriel Wong
Time Horizon: early November – early December
PnL: ($37.5)

Thesis: Given that the corn harvest completes around November, there should be high supply and downward price pressure on near-term corn as we move into December. Corn yields for this year were strong, which also supports the near-term short. This may lead to a decrease in acreage allocation for corn next year too, which supports going long the later-term corn. Thus, the original trade was short Dec/long Mar. However, since the corn term structure is in contango and the December contract will expire soon, the long March leg is more sensitive to negative macro/interest rate news. To hedge out this sensitivity to short-term news given the negative macro sentiment regarding Europe, the trade was switched to a butterfly spread, going long an extra March contract and short July.

Result: There was almost no movement in the trade, given the short time horizon and the low volatility of corn.

Trade: short December Wheat/long December Corn by Gabriel Wong
Time Horizon: Nov. 8-15
PnL: $2,075

Thesis: A few world grain market reports were released recently, indicating an oversupply of wheat. Long-term trends have been moving away from wheat towards corn and soybeans, due to the latter two being more versatile as animal feed, ethanol and oil. This is a very short-term trade to capture the market reaction to the upcoming USDA report.

Result: The market reaction to the report went in our favor, with wheat dropping around 3%.
Trade: long January Reverse Soybean Crush Spread (short Soybeans, long Oil/Meal) by Gabriel Wong
Time Horizon: mid November – mid December
PnL: $92

Thesis: Technically, the spread traded at its 5-year low in September (between 20 and 35 cents/bushel), hovered below the peak at 40 until October, and recently broke the peak. The past week saw a reversal of a short downtrend, where the spread was unable to break the peak at 40. Thus, my target for the short-term is for the spread to go up to 58 (the next peak, which held in Feb and Apr), with a stop-loss if the spread goes below the 40 support.

Fundamentally, the US soybean harvest ended recently and yields were strong. Due to decreased exports to China, soybean demand is down, stocks are up, and there is downward price pressure on soybeans. Meal/oil, on the other hand, should maintain a more stable price, due to more consistent demand of the actually-used product. Thus, the spread should go up/diverge.

Result: The trade went in our favor as soybean prices continued to fall, while oil/meal were less sensitive to these price drops in soybeans.

Currency Trades

Trade: short straddle (1.335 strike, January expiration) on Euro FX Futures by Gabriel Wong
Time Horizon: December 6-13
PnL: $462.5

Thesis: The other 10 Eurozone summits this year resulted in mostly neutral/slightly negative market reactions, but nothing very severe. With the hype surrounding the upcoming Eurozone summit, it seems profitable to sell a straddle, which would make money if it expires in a month between 1.29 and 1.38 (a 3.4% move in either direction, which does not seem likely in such a short time horizon).

Result: There was little market reaction to the summit on Friday, with the forward rate rising slightly from 1.335 to 1.34. However, on Monday/Tuesday the forward rate dropped from 1.34 to 1.31. This sudden movement increased the riskiness of the trade, so I closed it out. At this level, the premium from the worthless OTM call outweighed the value of the slightly ITM put, so there was a small profit.

Long USD/JPY by Irving Franco

When the yen was straddling around 76 per dollar, I knew the Bank of Japan needed to do something to weaken its currency. Japanese exporters had been complaining for some time about the strong yen, and with the yen breaching unprecedented levels of strength, the sense of urgency for monetary action could not have been more imperative. With this in mind, I took a long position on USD/JPY, on the expectation that the central bank would soon take some kind of dramatic action to weaken its currency against the dollar. Soon after I entered the position, the Bank of Japan intervened in the currency markets, weakening the yen. I later exited the position upon noticing that the fix was only temporary and that investors were still demanding yen in the face of uncertainty around the world.

Short EUR/NOK by Irving Franco

As the situation in Europe continued to look bleak over the course of the fall, I began to look for some safe haven against the euro. The Norwegian krone looked particularly appealing because of the country’s relative
economic stability. The Norwegian economy is primarily driven by natural resources. It is the 7th largest oil exporter and 2nd largest natural gas exporter. Its entire oil industry is controlled by the government, and any profits go towards a sovereign wealth fund. This very fact has thus far shielded the Norwegian government from the kind of debt crises that many other European governments have been facing. The Norwegian central bank had predicted healthy economic growth figures for the next year, and had announced that it does not intend to provide any kind of monetary stimulus for the next year. The combination of these facts led me to believe that the krone would serve as a safe haven against the euro. I took a short position on EUR/NOK, and noticed that when news out of Europe was bad, the position would benefit, and vice versa. The position has been mostly positive since its onset. My thesis remains that in the long run the euro will take a hit against the krone. The position is still on the portfolio.

Long USD/CHF by Irving Franco
Building on my pessimism against the euro, I took a long position on the dollar against the franc. Initially, the correlation between this position and the performance of the euro may seem to be nonexistent, but my thesis was that in fact there is a correlation. The way this correlation works has to do with the ratios between three separate currencies, the dollar, the franc, and the euro. USD/CHF is essentially the ratio of USD/EUR divided by CHF/EUR. When world currencies advance against the euro, USD/EUR presumably increases, but CHF/EUR does not actually increase. That is because EUR/CHF is manipulated by the Swiss National Bank so as to never dip below an exchange rate of 1.20. The bank continues to enforce this policy relentlessly because the franc is too strong for the Swiss economy to survive for long. It was thus my belief that a continuing decline of the euro would boost demand for dollar against franc. I took a long position on USD/CHF, and the position still remains on the portfolio. It has performed very well since its onset.

Short USD/CAD by Irving Franco
As positive economic news started coming out of the US late in the fall, I saw an opportunity in Canadian dollar. That is because as the US economy prospers, Canada’s economy benefits tremendously because of its exposure to the US economy. Indeed, Canada’s economy had been performing well in 2011 and is expected to continue its robust growth next year. Monetary stimulus is not even a thought in Canada, even in the event of a euro meltdown. On the contrary, there is speculation that the Canadian central bank may actually raise interest rates within the next year to counter high inflation. All this positive news for the Canadian dollar, along with speculation that investors will shift away from US dollar in the face of positive US economic reports, led me to believe to take a short (albeit relatively small) position on USD/CAD. The position has been mostly in the red since its onset, but I am keeping the position on because my thesis still holds.

Long CAD/CHF by Irving Franco
Given my optimism on the Canadian dollar, combined with my pessimism on the Swiss franc, I decided to take on a position that would combine the two currencies. I took a long position on CAD/CHF amid further speculation that the SNB may weaken its currency by raising its EUR/CHF floor from 1.20 to something like 1.25 or 1.30. Such action seemed more likely than ever as new, grim economic reports in Switzerland started reflecting a larger deflation problem there. This position has been fluctuating, but I believe that in the long run, it will benefit tremendously.

Short EUR/TRY by Deependra Mookim
The Global Macro Portfolio entered a short position of 20,000 units on EUR/TRY, expecting an oversold Turkish Lira to rebound from its lows of the year. Before we took the position, the lira
had dropped 10% in September of 2011 alone. We believed that fears of the adverse effects from inflation, current account deficits, and the European debt crisis were mitigated by impending developments in monetary policy as well as the country’s strong economic fundamentals. The former refers to our belief that Turkey would address concerns of an overheating economy through monetary policy; this belief was validated as the Turkish Central Bank acted to curtail credit expansion of domestic banks. The Central Bank also intervened directly into foreign exchange markets to stem further depreciation in the lira. Turkey has enjoyed nearly double digit GDP growth in 2011 even in the face of a slowing global environment, and we anticipated the country’s favorable demographics, low public debt, and stable government to sustain steady growth in the long-term. The Macro Portfolio realized a profit of $1261.56 as our long-term investment thesis held true and benefited from the Central Bank’s actions.

**Equity Trades**

**Long LVHM by Diana Hong**
Overall, LVHM went from $29.57 per share to $28.29 a share, yielding a cost of - $470.
I chose to go long on LVHM because emerging markets, especially China, are buying more luxury goods. As they develop, this will continue to happen.
Consumer confidence index has increased from 40.9 in October to 56.0, which is the highest it has been since July. So it is likely that people will start buying more, especially since the holiday season is approaching. As the holiday season approaches, the wealthy often travel, which means they’re likely to make more purchases.
Historically, LVHM has shown to be strong, even during financial crises, as it is not as negatively affected by the bad economy like many other retail companies are.

**Long MBG by Diana Hong**
Overall, MBG went from $27.62 per share to $27.87 per share, yielding a profit of $75.
I chose to go long on MBG because mortgage backed securities are ideal for investors because they are very safe and pay higher interest rates than Treasury bonds.
Compared to the other mortgage backed securities such as VMBS and MBB, MBG has had a higher YTD yield. Also, Fannie Mae is the largest holder of MBG. Fannie would likely have a higher yield than Ginnie Mae and Freddie Mac because it is not as secure as Ginnie Mae and Freddie Mac.
However, overall, mortgage backed securities are still very safe, so going long MBG would provide safety, but still allow potential for growth.

**Long EIDO by Deependra Mookim**
We invested in iShares MSCI Indonesia Fund due to our positive fundamental analysis of the Indonesian economy and its stock market. The country benefits from a cheap labor force and an expanding middle class from impressive GDP growth in the recent past. We believed that concerns about low foreign direct investment and exposure to slowing European demand are overstated by institutional investors. Exports account for a relatively low percentage of Indonesia’s economy compared to other developing nations, and worries about foreign direct investment have been addressed in part since we initiated the position. For example, Standard and Poor’s upgraded Indonesian sovereign and private debt to investment grade to better reflect the country’s low debt load and solid fundamentals. The Indonesian government passed legislation to strengthen long-term infrastructure development, which we think is positive stimulus in the short-term as well as a signal that Indonesia is serious
about FDI. The position remains open due to the long-term nature of our investment thesis with a loss of $227.90.

**Long BSBR by Deependra Mookim**
The Portfolio also initiated a long position in Banco Santander Brasil (BSBR) due to the Brazilian bank’s attractive fundamentals and valuation. While Brazil faces key headwinds, namely inflation and a rising real, the country’s domestic credit markets are relatively underdeveloped with much room for expansion. Domestic credit as a percentage of GDP stands at 55.71%, which is comparatively low to other developing nations. Furthermore, the banking industry in Brazil is highly concentrated, and we expect Banco Santander to be able to reap excess profits from this oligopoly into the future. With respect to company-specific analysis, Banco Santander is as operationally efficient as its peers, and it has an advantage in conducting global business through its ability to leverage Banco Santander and the bank’s reputation. Banco Santander Brasil does not rely upon Banco Santander for funding, but the Spanish bank does own a stake of the company that will be sold to meet regulatory requirements. We believe the market has overreacted to the dilutive effects of the sale, and we will continue to monitor Banco Santander’s financial position closely into the future. The position is currently open with an unrealized gain of $1017.00.

**Long TX by Deependra Mookim**
We took a position in Ternium (TX), a Latin American steel conglomerate, and our investment thesis relied on Ternium’s short-term developments as well as a technical analysis of the stock. TX fell 17% after the announcement of an expensive acquisition of a stake in Usiminas, a competing Brazilian steelmaker. While the premium was quite hefty at 83% of the previous close and the acquisition was made in light of slowing demand, we believe that TX investors overreacted to the acquisition. The acquisition of Usiminas does have its merits, as it gives Ternium more control over its raw material costs and provides more pricing power in Brazil’s domestic steel market, Latin America’s biggest market for steel. We saw the company’s separation from Europe as another attractive element: Ternium is not directly affected by a worsening European environment, as the steelmaker makes virtually all of its money in North America and Latin America. We captured a small profit of $204 as Ternium reverted to more reasonable prices and the market corrected the overreaction.